

# **The regulation of Insider Dealing in the European Union**

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Degree of Ph.D

University of Edinburgh

1994



**I confirm that this thesis is my own work, has been composed by myself, and does not include work submitted for any other degree or professional qualification.**

# UNIVERSITY OF EDINBURGH

## ABSTRACT OF THESIS (Regulation 3.5.10)

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*Degree:* Philosophy Degree (Ph.D)

*Date:* 30 September 1994

*Title of Thesis:* The Regulation of Insider Dealing in the European Union

*No. of words in the main text of Thesis:* 85,750

A precondition as well as a consequence of the increase in global business is the accomplishment of access deregulation. The latter should coexist with the complementary process of prudential re-regulation, in spite of the fear of regulatory arbitrage. Harmonising the different regulatory systems is essential in reducing inconsistencies among national regulations and in achieving unification of the European Internal Market. Reciprocity or Mutual Recognition of standards is also a basic criterion of the Community policy towards the liberalisation of the EU financial markets and the abolition of internal barriers. The main objective of the EU policy regarding securities regulation and, in particular, insider dealing is to establish a basic framework for the protection of investors and, thus, encourage greater confidence in the financial sector.

The *raison d'être* of the insider dealing regulation is based on the concepts of market integrity, morality and fairness. Economic arguments still support the view that insider dealing is not so obviously detrimental that it needs to be prohibited. Economists have even argued that insider dealing can make stock markets work more efficiently. The US experience suggests that the broad scope and flexibility of insider dealing rules have been proved to be their weakness and make them susceptible to judicial abuse. In European countries, legal theory followed three successive objectives: the protection of the Company (or fiduciary theory), the protection of the market and, finally, the protection of information.

The EC Directive on Insider Dealing takes a positive step towards harmonising the insider dealing laws of EU States. The efficiency of the Directive depends greatly on the severity of sanctions that will be enacted in the Member States. The Directive, being a compromise text, has not always adopted the desirable solutions. The UK Criminal Justice Act 1993 reflects the Directive well but fails to alter any of the sanctions or enforcement procedures that were the main shortcoming of the previous British legislation. The implementation of the Directive by the Greek legislator in Art. 30 of Law 1806/1988 and PD 53/1992 is in conformity with the EC policy. The Greek legislation constitutes an important effort to protect a still unsophisticated market from an anti-economical practice and to make all persons involved in stock market transactions more sensitive about the offence.

Insider dealing is often a multi-jurisdictional offence and its prosecution is largely dependent on international conventions both at an EU and an International level. Finally, the task of regulating insider dealing is characterised as the "*art of the possible*" given that the most sophisticated rules cannot create an *oasis* of informational equality and the proposal for the formation of a European Securities Commission is expressly supported.

## ACKNOWLEDGEMENTS

I should like to express my gratitude to my supervisor Professor John Murray. My work was supported for the last two years by the educational grant of the A. G. Leventis Foundation. I should, finally, thank my mother who encouraged me to complete this project.



**To my parents**

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## **A. Introduction**

### **Deregulation and Reregulation: Two tendencies**

#### **I. Conceptual Framework<sup>1</sup>**

##### **a. Access Deregulation.**

Since the beginning of 1993 the European Community has become a single integrated market without internal frontiers in which the free movement of goods, services, persons and capital is ensured.<sup>2</sup> To this effect a legislative programme has been adopted by the Community with the aim of removing the remaining barriers to free movement.

The freedom to provide financial services is an indispensable facet of the achievement of the single market.<sup>3</sup> In the securities sector the ultimate aim is to promote a Community-wide trading system for securities, resulting in the creation of a European securities market.

A precondition as well as a consequence of the increase in global business is the accomplishment of deregulation.<sup>4</sup> George Stigler provides a useful definition for regulation: it is "any policy which alters market outcomes by the exercise of some coercive government power";<sup>5</sup> whereas deregulation can be loosely defined as the removal of competitive barriers and is undeniably a driving force for European Financial Integration.<sup>6</sup>

The starting-point of the movement towards deregulation can be traced in the early seventies in the US. It was the stock exchange of New York that saw the first "Big Bang" in 1975-76 with a deregulation of broking practices which led to a deep transformation of the conditions of competition.<sup>7</sup> It was only 10 years later that the first great reform of the same type took place in Europe, this time in the City of London.

An important distinction between the identifiable types of deregulation must be made from the outset: First, by "*Access deregulation*" is meant the reduction or elimination of regulatory barriers, (such as exchange and capital market controls) in such a way that regulatory structures are modified to facilitate foreign participation in domestic markets.<sup>8</sup>

"*Access deregulation*" must be distinguished from "*prudential deregulation*" which relates to the removal of rules primarily designed to protect markets from abuse, illiquidity and uncertainty. The latter is often justified on the basis of *laissez faire* political policies and free market efficiency theories. As one writer points out, Europe's (access) deregulatory wave has been accompanied by virtually no prudential deregulation.<sup>9</sup> It is remarkable that, if anything, the tendency has been towards an increase in regulation, as the efforts for re-regulation indicate.

In the Continental type of access deregulation there is an additional ingredient leading in most cases to a different, probably more complete, form of deregulation, than the US or UK deregulation reforms usually achieve. Whereas the deregulation of commissions (*la déregulation des commissions*) has been the principal characteristic of the American reform (which does not in itself constitute access deregulation while the latter is promoted only through secondary measures, aiming at the opening up of the market e.g. on "offshore" offers), the despecialisation of intermediaries (*la déspecialisation des intermediaires*), that is, the end of a monopoly or quasi-monopoly of a certain category of intermediaries, has played in a number of European countries a role at least equally important in the transformation of competitive conditions. Several markets have combined to various degrees the two aspects: deregulation of broking practices and despecialisation of intermediaries.<sup>10</sup>



In an attempt to examine the reasons for this differentiation, it must be realised that access to European Stock Markets has been mainly influenced by two different traditions. A number of the "germanic" countries - Germany, Austria, Switzerland, Luxembourg - have operated under the regime of the "*universal bank*", the bank that engages in all forms of banking activity, including investment banking or the holding of shares in public companies. In these countries the credit establishments have the right to operate directly in the Stock Market. The Dutch model is also close to that system.

In the Member States with a Napoleonic tradition, such as France, Italy, Spain, Belgium, access to the market is reserved to specialised Intermediaries, the stock brokers or "*agents de change*", who benefit from the monopoly of the execution of orders.<sup>11</sup>

The UK, post-Big Bang, is moving towards a universal bank system with many of the large broking houses now subsidiaries of banks. The same trend is being followed by the French, Italian and Spanish securities markets. This trend towards a universal bank system is evolving due to increased internationalisation of securities trading and its prohibitive cost, the technological expertise required to trade long-distance and increasing diversification of products.<sup>12</sup>

In conclusion, different reforms are required in different markets but the end is everywhere the same: not only to increase the efficiency of national markets, in the interest of investors on the one hand and of that of issuers on the other, but equally - and more importantly - to enhance the attractiveness and competitiveness of the financial market concerned.<sup>13</sup> The latter aspect has become, in the recent past, the main concern of the member state regulators. As the deadline for the Global Integration of the EC is well behind, it is with a view to fostering the



European Market of Financial Services that the Community legislators have to adjust and update the rules of the game.

#### **b. Prudential Reregulation**

The overdue process of financial deregulation has been set in motion by the legislative instruments of the Community. The movement, however, towards deregulation must not be guided by the oversimplistic concept that a market can be un-regulated.<sup>14</sup>

Economic analysis suggests that regulation is necessary and desirable when market mechanisms reveal shortcomings. Design and control of the financial industry and markets can be both explained and justified along these lines.<sup>15</sup>

Even in the most liberalised financial centres, all the major types of financial institutions are regulated.<sup>16</sup> Firstly, because the stability of the financial market is generally perceived as a "*public good*" and its maintenance can not be guaranteed by market forces. Secondly, in order to protect all kinds of investors against the risk of fraud, to which financial markets have always been exposed.<sup>17</sup>

The very functioning of financial markets requires therefore regulation, which should, however, be designed in the light of market deficiencies in general, with a view to preventing them, or, at least, to warding off their negative effects insofar as possible.<sup>18</sup>

The regulatory policy adopted by the commission has the twin objectives of ensuring that the Community financial market is opened up and that so doing does not place in jeopardy either the stability of the banking system or the protection of consumers. The differences between the regulatory systems frequently increase obstacles to cross frontier competition. As the Director-General for Financial Services of the

Commission remarks with felicity: One man's prudential regulation is another man's trade barrier.<sup>19</sup>

In the aftermath of deregulation it soon became clear that it had to be accompanied by RE-regulation. The very nature of the financial system calls for a complex process of deregulation and reregulation. The latter term signifies the various kinds of legislative activity "undertaken to address the perceived shortcomings of regulatory systems", becoming apparent by reason of deregulation.<sup>20</sup>

As with the term deregulation, the necessary distinctions between access reregulation and prudential reregulation must be made: Whereas access reregulation resurrects old barriers to globalisation, prudential reregulation establishes "a regulatory scheme more appropriate for newly accessible markets".<sup>21</sup>

Access deregulation and prudential reregulation should coexist in the face of financial innovation. A combination of those mutually complementary processes can improve a market's efficacy and at the same time strengthen the confidence of investors. This approach implies a thorough re-examination of the relevant regulatory and supervisory arrangements. Fundamental changes and adjustments will be indispensable if today's national systems based on differing principles, are to coexist in a stable integrated environment.<sup>22</sup>

Prudential reregulation aims at encouraging and promoting incremental investments in securities markets under expansion by providing a favourable (regulatory) environment for their development. Markets that have become "more liquid, flexible, innovative and volatile" as a result of access deregulation,<sup>23</sup> may also need the complementary control of prudential reregulation.



An important example of such a process can be drawn from the UK experience and, in particular, the enactment of Financial Services Act 1986, the aim of which was to provide the legal framework for all types of financial business. The Act introduced a new concept: Voluntary self-regulation within a statutory framework and by this system replaced the "uninhibited" form of self-regulation which had been traditional in the City of London.<sup>24</sup> In addition, the Act tried to strike a fair balance between the interest of investors, private and institutional, professional financial operators and the public.

Every Member State of the Community has taken legislative steps to reform. Although different in shape, those reforms are invariably dictated by the necessity of prudential reregulation.

### **c. The *bogy* of Regulatory Arbitrage**

Two contradictory theories regarding the motives that dictate the choice of regulatory environment can be identified:

The historical precedent of New York and London markets that have emerged as the leading international money markets despite having the two most comprehensive securities regulatory systems in the world,<sup>25</sup> supports the inference that the most severe regulatory environment (probably offering prestige) does not necessarily act as disincentive to financial institutions or investors.

On the other hand there is the concept that financial institutions will aim to locate themselves in the least stringent regulatory forum. The lowering of regulatory barriers by national authorities, as a result of Access Deregulation, combined with the emergence of the home country principle, has paved the way to *Regulatory Arbitrage* which is closely related to competitive deregulation.

The term *Regulatory Arbitrage* signifies that financial institutions will be attracted by a jurisdiction where they could operate in a market which is not subject to relatively more stringent rules governing disclosure, manipulative conduct, and other regulations protective of investors.<sup>26</sup> While the choice of a more liberal regime exists, no investment firm wants to end up "in some oasis of splendid regulatory purity".<sup>27</sup>

It is the fear of regulatory arbitrage that can impose a severe restraint on the complementary process of prudential reregulation and can obviously lead to competitive deregulation.<sup>28</sup>

After the abolition of currency exchange and capital market controls the fear of the regulators focused on the possibility of economically damaging capital flight.<sup>29</sup> An official of the UK Securities Association (TSA) has stated that, "if the level of regulation is too high the major players move out of the EC to Zurich. The market is like a piece of soap . If you squeeze it too hard it squirts out elsewhere".<sup>30</sup>

In spite of this menace, no inference can be readily drawn that competitive deregulation is an answer to the perplexing problems posed by the "Europeanization" of financial services.

The resolution of this dilemma should not be left to competition between regulatory systems, but lies in the achievement of a regulatory equilibrium within the EC, combining a dosage of minimal harmonisation and mutual recognition which is likely to lead via the second of these principles, to competition between supervisory frameworks with a gradual convergence on the arrangements that best meet the needs of the market.<sup>31</sup>

Each national regulatory system has to be amended so as to compete on equal terms with the others in view of the harmonisation process



carried out pursuant to Community provisions and, hence, in accordance with a supranational prudential framework.

The objective of the preliminary formulation of a homogeneous core of supervisory rules is, thus, to prevent excessive deregulation and limit the risk of distorted competition.

Despite the efforts made, after the integration deadline, the fear of regulatory arbitrage still looms large, influencing the decisions of both regulators and regulated.

#### **d. Harmonisation and alternatives**

The greatest obstacle to the unification of the European Internal Market is the variation in legal systems and regulations among Member States. Harmonising the different regulatory systems is an essential precondition for removing that obstacle.

The concept of regulatory harmonisation is closely interrelated with those of deregulation and reregulation. Whereas access deregulation facilitates access to markets and prudential reregulation provides protection to the newly accessible and de-regulated markets,<sup>32</sup> the objective of harmonisation is to reduce the inconsistencies among national regulations and, thus, ward off the danger of arbitrage generating simultaneously higher levels of protection.

The term harmonisation as used in European parlance, signifies the achievement of common regulatory requirements that envisage the development of substantially equivalent or uniform rules, governing all major issues, such as disclosure, insider trading, market manipulation, conflicts of interest and fraud.

Professor Warren calls this achievement of common standards "*commonality*", because he gives harmonisation a wider meaning, as

being the international accommodation of diverse regulatory regimes. The latter notion embraces both "commonality" (harmonisation) and mutual recognition (or reciprocity).<sup>33</sup> In this text the term will be used in the narrower sense to refer to the achievement of substantially equivalent regimes.

Harmonisation can yield enormous benefits related to the promotion of universal investor confidence, whether it is effected through the independent enactment by national governments or in consequence of community legislation.

Taking the example of disclosure, common standards would produce uniform and, hence, comparable information for making investment decisions that could involve a number of states. The acceptance and trading of securities according to common standards would increase opportunities for issuers and investors. In the long run, the accomplishment of an International Data Base could provide invaluable assistance to securities analysts.<sup>34</sup>

The harmonisation approach though, has been proved unrealistic in practice in view of the difficulties in agreeing on uniform rules and convergent standards. Harmonisation would clearly be favoured by the states with more exacting requirements in an effort to reduce any competitive disadvantage, if those standards were to be adopted, whereas this possibility would meet a negative reaction by the Member States that would prefer the adoption of a "lowest common denominator" approach for the fear of capital flight.

The EC measures on company and securities law illustrate a "pragmatic shift" from harmonisation to reciprocity. A significant departure from previous Commission attempts to progress towards a Single European Market, which has relied on harmonisation of national



laws and regulations at every level (article 100 of the Treaty of Rome), has been marked by the 1985 White Paper.

The innovative element of the White Paper was contained in the form of the dual strategy of minimum harmonisation (which is not necessarily the same as the lowest common denominator approach ) and mutual recognition. The intention of the Commission is to decrease the role of harmonisation, as it believes that the new approaches lead to quicker and less problematic progress.<sup>35</sup>

#### **e. Concept of Mutual Recognition**

A key political issue in any discussion on European integration is Reciprocity, often used synonymously with the term Mutual Recognition or even called the single licence (*licence unique*).

It was the more recently adopted approach towards the European Integration. This is not simply a financial services issue but rather cuts across the whole spectrum of economic activity in Europe.<sup>36</sup>

Reciprocity or Mutual Recognition can be achieved through the conclusion of a reciprocal agreement in which each state agrees to recognise and accept for its own regulatory purpose the regulatory requirements applied by the other. It is based on substantially equivalent minimum standards.

Because of its relative ease of implementation, it can achieve integration more easily than harmonisation, and may prove a necessary first stage in the harmonisation process.

It is important to understand that the terms are not mutually exclusive. Indeed, harmonisation in the form of common general principles or detailed rules may create the indispensable infrastructure for reciprocity. On the other hand, mutual recognition should aim at

encouraging, the development of substantially equivalent regimes world-wide as other states attempt to secure greater access for their financial institutions to more highly-developed markets. Professor Warren concludes that: "reciprocity based on substantial equivalence may serve as foundation upon which to build a global securities code."<sup>37</sup>

The Commission while it is still envisaging harmonisation for the standardisation of basic rules, supports nevertheless the supplementary concept that technical standards which differ between Member States should be mutually recognised in order to allow goods and services originating from an other Member State, free access into a National Market.<sup>38</sup>

By extending the idea of mutual recognition to the provision of services, the Commission envisaged that Member States would adopt a procedure of home country control. This would involve the supervision of European-wide activities being the responsibility of an appointed authority in the Member State, in which a company has its head office. In moving towards the principle of mutual recognition, the White Paper proposed to speed up the decision making process and reduce the regulatory burden of companies wishing to operate on a Community-wide basis.<sup>39</sup>

Regulators however in the EC should beware of the danger that governments with more stringent regulation like the UK will give a more liberal interpretation to "substantial equivalence" in order to attract foreign investment, a policy which is bound to provoke the reaction of domestic firms demanding regulatory parity in order to compete on equal terms with their foreign counterparts. Those sharply contrasting interests could lead in a reduction to the least common denominator, instead of making an effort to gradually level up global regulatory standards.<sup>40</sup>



It can not be overemphasised that the objective of the reciprocity provisions is not to close the internal market to third countries, but on the contrary to encourage a parallel opening up of the markets and to enable the Community to ensure that its financial institutions enjoy fair access to third countries' markets.<sup>41</sup>

The completion of the internal market and abolition of internal barriers makes it necessary to foresee from a Community standpoint the regulation of the access to the EC market by third countries' financial institutions. The criterion of reciprocity still remains the cornerstone of the Community policy in moving towards liberalisation and the establishment of the world's only multinational financial services market.

**f. Now superseded by a more complex approach?**

As has become clear, the very detailed comprehensive harmonisation approach (which enjoyed popularity in the late 1960s and early 1970s) has gradually given place to the mutual recognition approach.

Building on the principles of the treaty and legislation already adopted by the Community, the White Paper has proposed a three stage general method which supersedes earlier approaches:

*Firstly*, the **harmonisation** of essential standards for prudential supervision of financial institutions and for the protection of investors, depositors and consumers.

*Secondly*, **mutual recognition** by the supervisory authorities of financial institutions in each member state of the way in which they apply those standards.

*Thirdly*, based on the first two elements, "**home country control and supervision**" (i.e. control and supervision by the Member State in which the financial institution is based) of financial institutions which wish to

operate in other Member States either by establishment or by offering their services directly across frontiers.<sup>42</sup>

## **II. Securities integration in the EU**

### **a. National objectives to date**

The expansion of retail securities markets is a relatively recent phenomenon in Europe. Even in the UK, the Member State with the most developed securities market, as late as 1980, less than three per cent of the population owned company shares.<sup>43</sup>

Despite the diversity within the financial services sector, the cultural differences between national financial services markets and the considerable differences in financial regulation at the national level, some explanations of general application can be found in the political and economic history, the customs and the tradition of European nations: The two world wars have resulted in major economic dislocations across the EC.<sup>44</sup> European governments intervened by imposing exchange and capital market controls and by dictating the commercial policies that should be followed by financial institutions.<sup>45</sup> Differing prudential regulations and controls as well as dissimilar legal and administrative systems were obstacles (particularly in the investment from other countries) that also had to be overcome by external investors.<sup>46</sup> A few countries imposed restrictions on foreign investment and screened projects to determine whether they were in the national interest. The boundary between such protection of national interest and discrimination against foreign investors was often tenuous. In the field of corporate



finance there was an indisputable predominance of bank lendings over securities offerings.<sup>47</sup>

Only a relatively small number of companies, in Continental Europe were listed, until recently, and each with a minority of shares available in the open market.<sup>48</sup>

The high transaction costs were an indication of an environment of insufficient or non-existent transparency and liquidity in European Securities markets. At the same time the absence of regulation affording investor protection resulted in popular aversion to the risk of securities investment. Lack of understanding and, moreover, lack of public confidence in the securities markets has influenced largely the operation of European Stock Markets.

The privatisation of many state-owned enterprises, as Prof. Warren points out, has undeniably enhanced wider individual participation in securities markets turning the latter into a high priority objective of national policy in a number of EC states. The privatisation of state-owned enterprises generally has required the development of supportive regulatory-based infrastructures.<sup>49</sup> Strategic considerations rendered mandatory at least the semblance of an investor protection scheme in order to maintain public confidence in an expanded retail securities market.

The 1992 programme of the European Commission to create a single market in Europe has had a major impact on the EC's financial services in general and on the EC securities industry in particular. Until the promulgation of the 1992 initiatives, progress toward market integration in the financial services sector was slow.

The programme to harmonise the securities industry involves the essence of community principles, namely **mutual recognition**,

harmonisation of minimum standards and co-ordination of regulation among national authorities.<sup>50</sup> Nevertheless, the codes are evolving without the benefit of strong historical antecedents in national regulation.<sup>51</sup>

Professor Gower has described securities regulation as "virtually non-existent" outside the UK. Despite the development of Company Law in various jurisdictions, stock-exchanges have been self-regulating without direct oversight by national governments.

Full disclosure systems for the distribution and trading of securities were not made mandatory by most European states. Manipulative practices and, above all, **insider dealing**, generally proscribed by US securities laws were not, until recently, prohibited in many Member States.

Insider trading in Europe has been described as "*rampant*"<sup>52</sup> and one writer recently commented that France and (West) Germany "assumed that insider trading was what financial life was all about".<sup>53</sup>

The overriding purposes of the EC programme are *first*, to establish a basic framework for the protection of investors, so as to improve the security of the Community's financial businesses and to encourage greater confidence in the financial sector, and, *second*, to remove barriers which currently exist among the various markets, thus allowing easier access to Community capital markets. This programme may be followed by further proposals leading to closer monetary co-operation and common exchange rate policies among Member States and, ultimately, the adoption of a common EC currency.<sup>54</sup>

The EC's Company and Securities Law directives generally have required each Member State to designate a competent authority to administer the resulting national legislation<sup>55</sup> in view of the lack of



governmental "competent authorities" or regulatory bodies to administer those regulations or to supervise self-regulatory organisations in the securities industry.

The Community's efforts to establish a Single European Market by 1992 have contributed greatly to the change of the regulatory tradition in the securities field.

Ultimately, the objective is to develop a **European Securities Code** flexible enough to adapt the regulatory framework to account for the new market realities and to maintain some regulation to protect consumer interests and guarantee the stability of the financial system.

**b. Progressive disappearance of National Monopolies - Development of the Single Market by 1992.**

A European financial common market without restrictions requires a single securities market where investors can issue and trade securities across national borders freely and without hindrance. The removal of all the numerous national restrictions still existing has become all the more urgent with the rapid internationalisation of securities markets and the need for the Community to achieve a dimension in this area equal to that of other major financial markets, such as those of the United States or Japan.<sup>56</sup>

In 1957 the Treaty of Rome established the European Economic Community for the express purpose of creating a common market without obstacles to freedom of movement for goods, persons, services and capital.<sup>57</sup> The Treaty provides for the progressive abolishment of restrictions "on freedom to provide services within the Community" (art.59) and of "all restrictions on the movement of capital belonging to persons resident in Member States and any discrimination based on

nationality or on the place of residence of the parties or on the place where such capital is invested" (art.67). It also states that "the liberalisation of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalisation of movement of capital" (art.61).<sup>58</sup>

The substitution of uniform standards for the widely disparate regulatory regimes of twelve states should provide easier, wider, and less costly access to suppliers of goods and services. The unified market will facilitate increased competition and stronger interrelationships among EC corporations. As a former EC commissioner succinctly puts it: "[it will] release the energies of the European Companies, facilitate their expansion into what are now distinct national markets [and]...help harness the inventiveness and experience of American and Japanese companies to Europe's development."<sup>59</sup>

The Community began early with its efforts to harmonise at least to a minimum degree the different regulations of the Member States on the admission of securities to stock exchange listing and the information to be provided to investors, and thus the protection of investors. As early as 1972 in a proposal for a first Directive in this area, the Commission stated that the omissions and differences in the information provided to the public regarding securities constitute a "second barrier" for capital movements between the Member States, which prevents the capital markets from benefiting in full from the advantages already achieved by the partial removal of currency restrictions. The second consideration, in addition to the provision of information for the public and the protection of investments, was the operation of a single securities market.

Since 1979 the Council of Ministers has adopted a series of important Directives in this area. The first stage was the adoption on 5 March 1979 of



a Directive co-ordinating the conditions for the admission of securities to official stock-exchange listing (79/279 EEC). The Directive sets out the conditions that must be met by issuers of securities, including the minimum issue price, the company's period of existence, free negotiability, sufficient distribution and the provision of appropriate information for investors. The Member States, however, were free to impose stricter requirements.

Closely connected is the Directive adopted by the Council on 17 March 1980 co-ordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock-exchange listing (80/390/EEC). The Directive lays down the many items of information which must be published when shares, debt securities and certificates representing shares are admitted to stock-exchange listing.

The third stage followed on 15 February 1982 with the Council Resolution on the Directive on information to be published on a regular basis by companies whose shares have been admitted to official stock-exchange listing (82/121). Under the Directive, companies listed on a stock-exchange must publish half-yearly reports on their activities, profits and losses.<sup>60</sup>

For almost 25 years after the EEC Treaty was signed, progress in financial integration was discontinuous, uneven, and on the whole modest. This can be attributed to a combination of economic difficulties and policy priorities, but also reflects the lack of coherent, comprehensive approach. Circumstances started to change in 1983-1984, by which time considerable progress had been made in correcting domestic and external imbalances in Community countries. In addition, pressure for deregulation and integration was created by financial innovation, the

rapid development of international financial markets, and the decision of some Community countries to dismantle their foreign exchange controls, notably their complete elimination by the United Kingdom in 1979.

In June 1985 the Commission presented to the European Council its White Paper on "Completing the Internal Market", which set the ambitious objective of complete integration of financial markets by 1992 and concretely identified the steps required to achieve it. A plan for the full liberalisation of capital movements was also presented to the European Council that year. Shortly afterwards, the approval of the European Single Act introduced in the EEC Treaty decision-making on a (qualified) majority basis for a broad range of Community matters, creating the conditions for speedier approval of legislation. Previously unanimity had been required.<sup>61</sup> The formulation of a comprehensive approach to the integration of financial markets, the agreement on a final date for its realisation, and the introduction of new procedures for Community decisions have created a momentum that was unthinkable only a few years ago. The Single European Act strengthened the legal framework for development of the common market.<sup>62</sup>

A milestone decision was taken by the Council on 18 November 1985 with two Directives on the free marketing of units issued by investment funds (undertakings for collective investment in transferable securities or UCITS). Both Directives implement for the first time in the securities sector the "new approach" called for in the White Paper on completing the internal market, namely the principle of mutual recognition of the legal provisions of the Member States based on a minimum level of co-ordination of national provisions and control by the country of registration or country of origin. A co-ordination Directive sets out the framework for the approximation of legal provisions so as to achieve



approximately equal conditions of competition and effective protection for investors in all EC countries. The provisions of the co-ordination Directive cover the field of application, the admission conditions, the structure of investment funds and their investment policy. Its provisions also cover the information to be supplied to unit-holders, the general obligations of funds, such as the ban on borrowing, the observance of the laws of the Member State in which the units are marketed, the rights and obligations of the supervisory authorities and the creation of a Contact Committee consisting of persons appointed by the Member States and of representatives of the Commission. Under a liberalisation Directive the Member States are required to remove all restrictions on the free marketing of units.

The "new approach" set out in the White Paper resulted in a further decision by the Council of Ministers. This was the Directive of 22 June 1987 amending Directive 80/390/EEC co-ordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock-exchange listing (87/345/EEC). The aim of the Directive is to ensure that listing particulars compiled in accordance with the earlier Directives and approved in one Member State are automatically recognised on the stock-exchanges of other Member States without the need for additional approval.

The Council took two further steps towards greater transparency in the latter half of 1988. On 12 December it reached an agreement in principle on a Directive on the information to be published when a major holding in a listed company is acquired or disposed of (88/627/EEC). The aim of the Directive is to ensure that investors and the public are informed of major shareholdings, changes in holdings above or below certain thresholds and changes in voting rights for listed companies in the

Community. The Directive requires certain action to be taken when a holding reaches 10%, 20%, 1/3, 50% and 2/3. The Member States may apply a single threshold of 25% in place of the 20% or 1/3 thresholds, and 75% in place of the 2/3 threshold.

On 17 April 1989 the Council adopted a Directive co-ordinating the requirements for the drawing up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public (89/298/EEC). The Directive is a further major supplement to the above mentioned 1982 and 1987 Directives on transparency and investor protection on the securities markets. In addition to numerous individual provisions, the Directive introduces for securities offered to the public for the first time a similar obligation to provide information to that contained in the 1980 general prospectus Directive for listed securities.

Also aimed at transparency on the securities markets and equality of opportunity in industrial restructuring was a Commission proposal of 1988 for a Directive on public take-over bids. The Directive is important mainly because with the completion of the internal market and increasing deregulation of capital movements, merger and take-over activity has grown substantially and is expected to grow further. The aim of the Directive is to approximate the very different legal provisions on take-overs in the Member States in order to ensure fairness of business dealings and equality of opportunity. The main provisions are directed at banning partial take-over bids, obliging a partial bidder (from 30%) to extend his bid to all the stock and ensuring that a bidder states in advance his intentions regarding the assets and activities of the Company concerned. Further provisions cover defence measures by companies for which public bids have been made, the retention of securities by a supervisory authority in



each Member State and reciprocity arrangements with non-Community countries.

Further initiatives by the Commission complete the programme for the creation of a Single European Securities Market. The proposal for a Council Directive relating to indirect taxes on transactions in securities of 14 April 1987 is aimed at abolishing indirect taxes on such transactions, following the failure to reach agreement on an earlier 1976 proposal on harmonisation in this area. The fact that taxes on stock-exchange transactions on major financial markets, for example in the United States or Japan, have been removed or are to be reduced is a further argument in favour of abolition. Investor protection, the removal of distortions in a single European financial common market and the combat of fraud are the subjects of the proposal for a Directive of 28 April 1987 co-ordinating regulations on insider dealing. *Insider dealing* (or *insider trading* in American English) is dealing in company securities with a view to making a profit or avoiding a loss while in possession of information that, if generally known, would affect their price.<sup>63</sup> The use of such 'price sensitive' information, which has not been made public, is prohibited by many legal systems. The Directive is aimed at harmonising the different codes of behaviour in the Member States. Growing abuse and spectacular cases have increasingly concentrated international attention on insider dealing.

Finally mention must be made of efforts to link EC stock-exchanges. Since 1984 the chairmen of the stock-exchanges of the Member States, in collaboration with the Commission, have been working on a stock-exchange link-up system known as the IDIS (Interbourse Data Information System). The Commission itself has completed an examination of how

links can be created or improved between the national clearing systems for securities transactions.<sup>64</sup>

**c. EC Company and Banking Law proposals.**

The magnitude and the scope of the EC initiatives in the area of securities regulation can only be evaluated in the context of a large number of closely interrelated Company and Banking Law directives which do not *prima facie* regulate stock-markets or securities but nevertheless play an undeniably important role in creating the appropriate legal environment for the effective operation of the market and the protection of investors.

Article 7 of the Treaty of Rome provides the impetus for the company law Directives. Article 7 prohibits discrimination within the European Community based on the nationality of an enterprise organised in a Member State. Companies organised under the laws of a Member State have the right to establish branches in other Member States. In addition, article 54(3)(g) requires that regulation for the protection of shareholders, employees and creditors must be equivalent throughout the EC. To this end, the EC initially proposed and adopted Directives aiming at the achievement of harmonisation through detailed common requirements.<sup>65</sup> It has already been mentioned that the harmonisation approach has proved (both at a political and legislative level) not to be feasible. The Member States insisted on: "retaining [the]...distinctive features of their domestic regulatory schemes."<sup>66</sup>

The "new approach" adopted by the Community in the Single European Act was in favour of reciprocity (or, in other words, mutual recognition) between Member States: The EC began to propose Directives



which prescribed only basic, essential principles, with a requirement of mutual recognition by Member States.

In the context of banking law, the White paper calls for a single banking licence, home country control and mutual recognition. These principles are incorporated in the 1989 Second Banking Directive.<sup>67</sup> All credit institutions authorised in one European country will be able to establish or supply financial services without further authorisation. They will be able to undertake all the activities listed in the annex of the Second Directive provided that these activities are not forbidden by the home country supervisor.

The list includes most activities of universal banks. The objective pursued by the European Commission appears to be threefold: free entry and provision of financial services throughout the Community, the establishment of a fair and level playing field with single banking licence, home country control, mutual recognition and minimal harmonisation on equity, accounting, ownership and participation in the non-financial sector and, finally, consumer protection. In this respect references are often made to the European Court of Justice case "Cassis de Dijon"<sup>68</sup> according to which control on the quality of a product is warranted but can be met fully by the *home country supervisor*.<sup>69</sup>

This study is an attempt to further examine the creation of the post-1992 Single European Securities Market in the European Community from the point of view of investment services by focusing on the problems of investor protection in the European Single Market with particular reference to the regulation of Insider Dealing. Special emphasis will be placed on assessing the results from the point of view of investor-consumer protection and on identifying the measures that still need to be taken.

It can hardly be contested that the achievement of a Single European Market in Financial and Investment Services is on balance beneficial. It provides investors with greater opportunities for high economic returns and diversification, and provides issuers of securities with broader markets in which to raise capital. The price of these benefits, however, is the Europeanization of fraud and increased regulatory complexity.

The Community's work on the regulation of dealing in securities, for the most part limited to those listed on official stock exchanges, has been inspired by two major concerns: On the one hand to ensure the smooth operation of Member States' stock exchanges, and, on the other, to promote a greater interpenetration of national markets in securities.

In order to do so, the Community took the view, that it would be necessary to guarantee a minimum Community level of investor protection, through harmonised disclosure requirements, what the Commission terms "information policy". The policy got off to a rather slow start, even by financial services standards, and by the beginning of 1979 could only boast a (non-binding) Commission recommendation for a European code of conduct on dealings in securities.

More recently and particularly since the entry into force of the Single European Act and the sudden progress of Community legislation on the free movement of capital, the Council has made fairly substantial progress in certain areas, the sufficiency of which in the long term remains, however, to be seen.

The Directives concerning transferable securities adopted so far have covered the admission of securities to stock exchange listing (conditions of admission, listing particulars and prospectus requirements), the continuing supervision of securities so listed (publication of information on a regular basis), and the regular operation of the market (acquisition



and disposal of major shareholdings, prohibition of insider dealing), while a recent proposal seeks to liberalise the provision of investment services throughout the Community by means of a single authorisation to be issued by the investment firm's home country authorities.

The most obviously "investor protection-minded" measure in this field is the Directive on Insider Dealing on which the Council adopted in November 1989.<sup>70</sup> As its preamble makes clear, the Directive is designed to protect that precious and sometimes rather fragile commodity, investor's confidence:

*"whereas the smooth operation of the secondary market depends to a large extent on the confidence it inspires in investors... [and]...such confidence...includes the assurance to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information;*

*whereas by benefiting certain investors as compared with others insider dealing is likely to undermine that confidence and may therefore prejudice the smooth operation of the secondary market in transferable securities; whereas the necessary measure should therefore be taken to combat insider dealing"*

The Council thereby takes a clear and forthright stand on a question which has exercised many national legislators, to what extent insider dealing should be considered fair business practice and an acceptable perk for those in the know through good fortune or hard work, or deemed morally equivalent to theft. Another problem, inextricably linked to insider dealing, is the legality of (price-) stabilising practices.

In any case, whether legal or not, on the national level the disparity in national provisions in the European Community (now renamed *European Union*) is such as to constitute an impediment to the creation of an internal market in unlisted securities.

Attention must be drawn to the degree of homogeneity that will be accomplished through the implementation by each Member State of the Insider Trading Directive, to the sanctions to be imposed for the infringement of the measures taken pursuant to this Directive which can be anything, criminal, civil or administrative provided that they are "*sufficient to induce compliance*", and finally to the repercussions (in the case of a request of information from a Member State) of a somewhat ill-defined concept of "*sovereignty*" into Community law as a limitation on the duties of a Member State.

Case studies of the implementation measures adopted by EU Member States would provide deeper understanding of the effect of the Directive. Assessment of the legislative efforts of each national legislator seems to be a rather unfeasible task. Attention will be focused, therefore, to two representative jurisdictions: those of the UK and Greece.

The UK is a common law jurisdiction with one of the most sophisticated international securities markets in the world and lengthy legislative experience in the field of insider dealing . With the exception of Ireland, that is also a common law country, all other EU Member States have civil law systems and comparatively novel regulatory *schemata* on insider dealing. Greece, among the latter, has a typically civilian system, with strong influences principally from the German and secondly from the French civil codes. The first criminal law statute prohibiting insider dealing was only introduced in 1988 (art. 30, Law 1806/1988), and was an attempt to comply with the Insider Dealing Directive proposals. In addition, the Athens Stock Market has come to flourish rather recently and is still developing. The examination of the impact the Insider Dealing Directive has had on the national laws of the UK and Greece, namely on two dissimilar legal systems, will contribute greatly towards the correct



evaluation of the Directive. The lessons which the UK's experience can give to the civil law countries of the EC will also be considered.

The approach adopted will also attempt to shed some light to the means of enforcement the EU has in its armoury. The role of the European Court of Justice particularly in the case of preliminary rulings recognising the direct effect of the Directive and possible infringement proceedings against Member States which violated EU legislation on investor protection should be examined.

The feasibility of the formation of European Securities Commission with an aim of promoting regulatory standards within the EU and the compatibility of the various proposals for common European listings and electronic linkage of stock exchanges, in relation to investor protection are interesting issues in the same field.

The ultimate aim of this study will be to develop a better insight of the problem of investor protection in the EU focusing on the Regulation of Insider Dealing within the EU and making suggestions for future moves.

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<sup>3</sup> idem

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<sup>5</sup> *Financial Institutions in Europe under new competitive conditions*. Edited by D.E.Fair and C.de Boissieu.(KLUWER,1990): XXI. "Banking Structure and Banking Stability after 1992", by Forrest H. Capie and Geoffrey E. Wood

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<sup>7</sup> *Financial Institutions in Europe under new competitive conditions*. Edited by D.E.Fair and C.de Boissieu.(KLUWER,1990): XV. "La Concurrence dans le Domaine des Valeurs Mobilières", by Georges Martin and Marc Van Turenhoudt

<sup>8</sup> M. G. Warren, *supra* note 1

<sup>9</sup> G.Stigler, *Public Regulation of the Securities Market*, 37 JBL 117/64. cited by M.G.Warren, *supra* note 1

<sup>10</sup> G. Martin & M. V. Turenhoudt, *supra* note 7

<sup>11</sup> *idem*

<sup>12</sup> M.G.Warren, *supra* note 1

<sup>13</sup> G. Martin & M. V. Turenhoudt, *supra* note 7

<sup>14</sup> Geoffrey Fitchew, *supra* note 2, p. 27

<sup>15</sup> *Financial Institutions in Europe under new competitive conditions*. Edited by D.E.Fair and C.de Boissieu.(KLUWER,1990): XXII. "Issues in Financial Regulation: Efficiency, Stability, Information", Rainer S. Masera

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<sup>17</sup> *idem*

<sup>18</sup> R. S. Masera, *supra* note 15

<sup>19</sup> Geoffrey Fitchew, *supra* note 2, p. 27

<sup>20</sup> M. G. Warren, *supra* note 1

<sup>21</sup> *idem*

<sup>22</sup> R. S. Masera, *supra* note 15

<sup>23</sup> P.Stonham, "Global Stock Market Reforms" 126-47 (1987), cited by M.G.Warren, *supra* note 1

<sup>24</sup> *Issues and Offers of Company Securities: The New Regimes*, John L. Powell, cited by M.G.Warren, *supra* note 1

<sup>25</sup> M.G.Warren, *supra* note 1

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## B. The reasons for an Integrated Insider Trading Regulation in Europe.

### a. *Raison d'être* of the Insider Trading Law.

The term insider dealing (insider trading) is defined by the '*Oxford Dictionary of Finance*' as:

*"dealing in company securities with a view to making a profit or avoiding a loss while in possession of information that, if generally known, would affect their price."*

Under the Companies Securities (Insider Dealing) Act 1985 (which was superseded by the Criminal Justice Act 1993) those who were or who had been connected with a company (e.g. the directors, the company secretary, employees, and professional advisers) were prohibited from such dealing on or, in certain circumstances, off the stock exchange if they had acquired the information by virtue of their connection and in confidence. The prohibition extended to certain unconnected persons to whom the information had been conveyed.

Before 1961, the practice of insider dealing was not illegal anywhere in the world. In that year the United States Securities and Exchange Commission published an opinion (Cady Roberts & Co.) suggesting for the first time that an insider with undisclosed information must either disclose the information or refrain from trading. Insider trading was there held to violate the Commission's Rule 10b-5, a very general statement making illegal any practice that "would operate as a fraud..." in connection with the purchase or sale of a security. U.S. courts upheld the SEC's interpretation of Rule 10b-5 in the celebrated case of Texas Gulf Sulphur (1968), and the financial world has not been the same since.

The roots of the aversion to Insider Dealing can not be easily traced. It is certainly not universally agreed that insider dealing is reprehensible, for "while some would view it as the unacceptable face of capitalism, others see nothing wrong with it and indeed even think it should be encouraged".<sup>1</sup>

The starting point of this debate must be the view expressed by Professor Manne in his book "Insider Trading and the Stock Market"<sup>2</sup> (1966) which asserted that the practice is, in terms of economic efficiency, "positively beneficial and ought not to be prohibited."

Those who condemn Insider Dealing base their view mainly on the concepts of market integrity, morality and fairness.

A deep paradox surrounding the justification of the Insider Dealing Regulation is the difficulty of singling out those harmed by it. This is one of the reasons that its harmfulness is doubted by some academic lawyers and economists.<sup>3</sup>

As Brenda Hannigan remarks it may not be a "victimless crime" if the Insider Dealing has occurred in a face to face transaction where some misrepresentation or some deliberate inducement to the other party might be established. In many such cases the law could provide a remedy apart from the one specific insider dealing rules would but, because of no legal (*e.g.* contractual or fiduciary) relationship between the victim and the offender, common law offered no help. It is not possible to establish any relationship between the insider and the outsider in "impersonal, anonymous, stock exchanges."<sup>4</sup>

Herzel and Katz point out that as far as Insider Dealing is concerned not only do we lack credible plaintiffs but frequently "the only identifiable candidates-for-victim demonstrably profited from the illicit trader's action."<sup>5</sup> The loss of individuals who voluntarily dealt in the market



would occur regardless of whether insiders acted and can not be causally attributed to "the initial non-disclosure of information and the subsequent market readjustment on disclosure."<sup>6</sup>

The absence of a causal link and an identifiable victim (which may indicate that remedies based on compensatory rationale are not appropriate<sup>7</sup>) does not mean that the practice should not be regulated.

Although there is some sense in saying that Insider Trading is a "victimless wrong", in an attempt at precise analysis an important distinction can be readily made: "Insider Trading lacks credible plaintiffs, not victims."<sup>8</sup>

In the *Diamond v. Oreamuno*<sup>9</sup> case, directors of a company, in breach of their fiduciary duties, sold their shares on the market at a favourable price, knowing that because of an increase in expenses profits had fallen drastically, before that information was made public. Subsequently, when the shares dropped, they were held liable to the company for the difference, although the company was not the party who had suffered that particular loss.

According to Fuld C.J: "It is true that the complaint before us does not contain any allegation of damages to the corporation but this has never been considered to be an essential for a cause of action founded on a breach of fiduciary duty. This is because the function of such an action, unlike an ordinary tort or contract case, is not merely to compensate the plaintiff for wrongs committed by the defendant but, as this court declared many years ago 'to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates."

In relation to the potential harm to the company the same judge remarks: "In addition, it is pertinent to observe that, despite the lack of any



specific allegation of damage, it may well be inferred that the defendant's actions *might have caused some harm to the enterprise*. [emphasis added] Although the corporation may have little concern with the day-to-day transactions in shares, it has a great interest in maintaining a reputation of integrity, an image of probity, for its management and in insuring the continued public acceptance and marketability of its stock. When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities." The Diamond case solution may not be available when insiders do not owe fiduciary duties.

Informational advantages and transactional inequalities will always be present in the market some times based on expert knowledge, superior experience, foresight and diligence.<sup>10</sup> Despite the undeniably utopian nature of the idea of market egalitarianism, it is argued that it should be possible to remove informational advantages "achieved unfairly through access to information which can not be obtained by others and which in all probability is being used by the insider in breach of some fiduciary or other duty."<sup>11</sup>

The primary concern of the regulators, since "market egalitarianism is an unattainable goal", is to maintain investor confidence in the market without impairing its liquidity and efficiency.<sup>12</sup>

The wave of privatization in the U.K. and the relative governmental policies have necessitated the creation of a "clean place" in which to do business. The *Roskill Report*<sup>13</sup> noted that "if the Government cherishes the vision of an equity owning democracy, then it also faces an inescapable duty to ensure that financial markets are honestly managed and that transgressors in those markets are swiftly and effectively discovered,

convicted and punished."

The catastrophic consequences of a loss of confidence in the markets became apparent in the crash of 1987.<sup>14</sup> Insider Dealing may make capital raising more expensive.<sup>15</sup> It is the need to prevent this occurrence that among others, dictates its prohibition.

Economic arguments still support the view that Insider Trading is not "so obviously detrimental that it needs to be prohibited."<sup>16</sup> Professor Manne denies that the prohibition of Insider Trading promotes and maintains the efficiency (*i.e.* the instant adjustment of prices to information not previously known) of and confidence to the markets.<sup>17</sup> In his opinion the prohibition can not enhance the flow of information to the market; on the contrary it inhibits the flow of information in a number of different ways: Insiders in possession of information do not deal. On the other hand, the prohibition, by suppressing information, makes it more valuable and, thus, creates an extra incentive for insiders. Prohibition may also have the undesirable consequence of uncertainty to individuals who do not deal because of doubts as to its scope and as to their position.<sup>18</sup>

Finally it is argued that insiders play a stabilising role by gradually easing prices towards the correct price. In Manne's view Insider Dealing "moves prices in the right direction towards the level correctly reflecting all the real facts about the company, thus ensuring that capital resources will be properly allocated."<sup>19</sup> The problem here is that capital is incorrectly allocated by the majority *i.e.* the outsiders despite the fact that it may be properly allocated by insiders.

Regarding Insider Dealing as a mechanism which instead of placing in jeopardy the efficient operation of the market "increases confidence in its pricing mechanism" is an oversimplistic approach. As Gilson &



Kraakman point out, the best way to achieve the beneficial effect of market pricing is to provide for immediate disclosure of the fact that insiders are dealing in order to get a much quicker market reaction.<sup>20</sup>

The effect of Insider Dealing on public confidence can not be clarified by any empirical evidence. American and British commentators suggest that the reactions of American and British shareholders amount to, if anything, complete indifference.<sup>21</sup>

The cost of capital raising and the difficulties involved in the relative procedures are inextricably linked to investor confidence in certain companies and markets. The question which arises in respect to investor confidence in companies is whether the (known or suspected) practice of Insider Dealing within a company has an impact on the market prestige of the company. Carlton & Fischel support the view that in the absence of any evidence that companies voluntarily take steps internally to prevent Insider Dealing, "it is clear that companies do not regard themselves as harmed in the markets."<sup>22</sup> Measures to this effect have been taken as a response to legal requirements (e.g. The Financial Services Act 1986) but not as a result of efforts to restore the company's investor confidence, made on the company's own initiative.

An important criticism against the economic arguments and Manne's theories has been expressed by Schotland in his review of Manne's book:<sup>23</sup> "Even if we found that unfettered insider trading would bring an economic gain, we might still forgo that gain in order to secure a stock market and intracorporate relationships that satisfy such non-economic goals as fairness, just rewards and integrity."

The use of "moral imperatives" to justify regulation, according to Manne and economists in general, is "a consequence of frustration at the inability to find a justifiable basis for regulation."<sup>24</sup>



The opponents of the regulation assert that "if we allow insiders (genuine insiders: directors, officers and employees) to trade on the basis of what they learn running the company, we are essentially offering them a special kind of compensation package."<sup>25</sup> Some lawyers and economists have argued that we should use this unusual fringe benefit.<sup>26</sup> Herzel & Katz denounce it as both an *ineffective* and *unpredictable* method of compensation.<sup>27</sup> It is ineffective because under it an insider's compensation would bear little relation to his performance or usefulness. "Everyone holding the information would be more or less equal, be he a porter or chairman of the board."<sup>28</sup> The method is unpredictable because under it neither the insiders nor the shareholders can really know in advance the order of magnitude of the insider's compensation. According to Herzel & Katz insiders would have less incentive to work hard, shareholders less incentive to invest and if the latter had been asked in advance, they would have never agreed to this type of bargain with their managers.<sup>29</sup>

The controversy on the justification of the Insider Trading Regulation still continues (apparently less fierce in recent years<sup>30</sup>). Professor Loss has expressed his standpoint on the argument with felicity: "[the strictly economic arguments against insider dealing] overlook the fact that it is important for the markets, as it is for the courts, not merely to do equity but to appear to do equity. Why should the public enter the markets if the rules of the game make it perfectly legitimate for insiders (and their friends and business associates) to play with marked cards?"<sup>31</sup>

**b. Information and the**

**i) General Trading Public**

**ii) Shareholders**

**iii) Managers**

A company is an information generator merely by its legal existence.<sup>32</sup> Although the availability of information in the public domain may be of vital commercial importance to a third party it has little or no "intrinsic monetary value and consequently professional search firms may conduct and report on searches at the Registry on behalf of clients quickly and cheaply."<sup>33</sup> Records required to be kept for inspection at the registered office, such as names of shareholders<sup>34</sup> and directors' interests<sup>35</sup>, or copies of service contracts<sup>36</sup> are sometimes "dauntingly difficult for the layman to obtain"<sup>37</sup> and at least for some people, difficult to analyze.

Another category of company information which is neither public, nor yet confidential is what a diligent observer, a "researcher" of the company's affairs could discover for himself or on behalf of others. According to Mitchell this information can be *physical* and *intangible*.<sup>38</sup> Physical information is, for example the information one can get by observing the premises of a company as a guide to its trading activity.

Intangible information is divided into two sub-categories, i.e. *internally* and *externally* generated. Company's brochures, advertisements, price-lists and other documents which are part of the promotion policy organized by its management and advertizing agents, and are aimed at receiving "as wide a public coverage as possible", constitute the *internal* information of the company which normally does not create problems of confidentiality .

Information about a company which is collected by third persons who are interested in it is characterized as *externally* generated information. It



comprises expert analysis and comments which will be published and pass into the public domain.<sup>39</sup> Any person who reads regularly the financial pages of daily newspapers or the specialist business periodicals can acquire "substantial knowledge" about a certain company.<sup>40</sup>

Under the Company Securities (Insider Dealing) Act 1985, s10(b) the level of public knowledge required to exonerate an insider is that the facts be "generally known".

The extent to which mere publication is an effective method of making facts generally known is still an open question according to one commentator.<sup>41</sup> From the London or Edinburgh Gazette to tip sheets as "*the Penny Share Focus*" or "*Fleet Street Letter*" the range and number of readers and the sophistication of information circulated to them varies dramatically.

This second type of information (both physical and intangible) is also to be regarded as public and "therefore not of a character which requires its generators or recipients to keep it confidential on pain of penalty if they do not."<sup>42</sup>

The test which must be satisfied is whether the public has access to the sources of information from which Investment Analysts make their predictions or informed assessors their assessments. Networked information (such as the one provided via the Stock Exchange Automated Quotations System or SEAQ to brokers and market makers) is also deemed to be public as soon as it is put up on the screen despite the different momentum in the possible reactions of professionals and private individuals.

The third category of information generated by a company is that which is *confidential*. Mitchell makes a distinction between '*insiders*' i.e. persons who are in possession of confidential information and '*outsiders*',



these who are not. Only the first term is normally given statutory recognition (as by the Company Securities (Insider Dealing) Act 1985) "but both express a concept which is readily understood both by professionals and lay people."

There is a tendency to treat the term "confidential" as synonymous to the term "unpublished" despite the fact that unpublished information about the company is not necessarily to be treated as confidential. On the other hand not all information which is treated by the company as confidential is liable to influence the judgement of a third person, an "outsider" in his dealings with the company. The yardstick mainly adopted for the regulation of insider trading, as we shall see, is that the information must not only be unpublished but have a price sensitive character, in other words to be capable of causing price fluctuations.

This is the reason why the sanctions imposed on insiders for breach of their duties are confined to companies with public listings on recognised stock exchanges and issues of advertised securities.

In recent years the so-called Efficient Capital Market Hypothesis (ECMH) has attracted a good deal of attention. According to Fama<sup>43</sup> there are both weak and strong forms of ECMH; the weak form maintains that only 'public' information will be fully incorporated into share prices; the strong form maintains that privately held information will also be fully incorporated. Most empirical evidence tends to support the weak form, but not the strong: evidence that insiders can regularly outperform the market appears to suggest that gains from trade are always available to those who possess private information. Because it is of the nature of the information to constitute a *public good*, efficient private exchange may be impossible.<sup>44</sup> The most convincing version of the Efficient Capital Market Hypothesis is the *semi-strong*.<sup>45</sup> The latter supports the view that prices

always reflect publicly available information and, consequently, no superior returns can be achieved on information that has already been made public. While it is possible for producers of information to obtain a private return by changing securities trading policies as well as by speculative trading in the capital market, the size of that return will be directly related to their ability to restrict or delay the dissemination of information. The social cost of that restriction will depend on the extent to which the information could be used to improve production plans in the goods market, or to improve the completeness of the market in risk-sharing assets.<sup>46</sup>

The explicit legal recognition of property rights in information, governing its acquisition and its use, would suggest that the rights to production and use of information should be legally defined in such a way that the effects of transaction costs are minimized. "That is to say, the legal placement of such rights of shareholders, managers and the general public should depend on the extent and cost of anticipated reallocation away from the legal placement. This framework can be applied to suggest a *normative* basis for the legal treatment of the trade in securities."<sup>47</sup>

The parties relevant to the legal placement of rights over information should not be restricted to shareholders and managers but should also include the general trading public<sup>48</sup>, since disclosure of information to the public influences production opportunities and occasionally improves risk sharing arrangements.

#### **i) The General Trading Public**

It has been argued mainly by Manne and by Gilson and Kraakman<sup>49</sup> that the proscription of insider trading could inhibit or curtail the flow of information into the market, to the detriment of the general public.



This could happen in three different ways:

Firstly it could delay information dissemination because knowledgeable insiders would be prevented from trading on the basis of information that has not been made public. This is rather a matter of timing of the release of information and not a question as to whether it will ever be released.<sup>50</sup>

Secondly the indirect effect of the proscription of insider dealing could be to prohibit desirable types of market activity.

Commentators on the EC Directive on Insider Trading suggest that it should not be so widely drafted as to include within its scope:

*'(a) the analyst who, by his own intelligence and researches, spots a potentially good or bad investment and deals or advises accordingly; (b) the dealer in securities who, for example, takes advantage of discrepancies in the prices quoted in London and New York'.<sup>51</sup>*

The same Directive has been criticised as having the effect of preventing 'whistle blowing'.<sup>52</sup> The stabilisation<sup>53</sup> practices, so common in the euro-bond market, could also be rendered illegal.

Thirdly, the proscription of insider trading could impose excessive compliance costs on the securities industry, thus affecting negatively the general trading public.

The main counter-argument which can be set against the arguments outlined above, according to many writers is the problem of '*adverse selection*' which arises "from the difficulties faced by market-makers in distinguishing insiders from outsiders [leading] to the higher bid-ask spreads."<sup>54</sup> This inevitably leads to the distortion of price signals and the reduction of capital market liquidity since some 'marginal traders' tend to be excluded. The general trading public is far from benefited from these factors.



## ii) Shareholders

It is argued that if insiders receive part of their compensation in the form of windfall gains from insider trading, this means that shareholders actually gain with insider trading, as the agent's demands for salary are smaller.<sup>55</sup>

Beyond the shortcomings of this standpoint that have been described in section B(a), Haddock and Macey argue that:

*'If insiders are risk averse, they will be unwilling to give up salary equivalent to their expected insider trading profits in exchange for the privilege of insider trading. Then the shareholders may decide to forbid insider trading when the shareholder group contains an unusually large number of investors who are particularly knowledgeable about the company. But unless shareholders are going to benefit somehow if insiders are prohibited from trading, they will prefer to permit insiders to trade and to share the trading gains in the form of lower wage rates for insider managers'.<sup>56</sup>*

The reasons why shareholders would be interested in prohibiting insider trading are somewhat obscure. "Moral hazard occurring through insiders profiting from bad news"<sup>57</sup> is a rather debatable problem. The opportunism practised by insiders in managerial teams and problems of allocation of property rights among the members of those teams may increase "policing" costs especially in the absence of legislation, thereby prejudicing the position of shareholders.

## iii) Managers.

The practice of insider trading by managers is inextricably linked with private gains which have also been christened as 'compensation' and

'incentives'. The 'compensation package' theories have been criticised as both ineffective and unpredictable.

On the other hand the proscription of insider dealing should be carefully drafted so as to avoid any substantial renegotiation costs on the part of particular groups and member states covered by the legislation.<sup>58</sup> A status-based regulation should not neglect the possibility of using disclosure of identity to ensure efficiency in capital markets.

Moreover any harmonization effort on an EU level must take into account the differing environments existing in member states as regards the roles of managers and of shareholders in the decision and risk-taking.

### **c. Arguments from the Economic Theory.**

An economic foundation for the insider regulation should meet two requirements. "First, it should explain how insider regulation increases welfare and, second, it should be general in the sense that it can be used in any securities market."<sup>59</sup>

The detection of an increase or decrease in welfare requires "aggregating utility changes experienced by different people."<sup>60</sup> It is impossible therefore to establish whether insider regulation increases or decreases welfare if the analysis does not go beyond the redistributory effects of insider dealing transfers. The latter constitute a most popular approach to the justification of insider dealing regulation, which for the present purposes is of no value.

The second requirement excludes the takeover incentive approach. It is generally admitted that one of the the objectives of insider regulation is the protection of the incentive of takeover bidders. In the capital markets



where unfriendly takeovers are a common feature this approach offers a basis for insider regulation, but this is not the case for markets where changes in corporate control do not work by means of takeovers.

Consequently, the arguments for and against insider dealing regulation should be mainly based on the investor and market-maker reaction approach, in an effort to present a case against insider trading and for government regulation.

*Informational asymmetry* as to the value of securities (or any durable goods in general) may lead to movements of these securities. The ultimate result of these movements is a transfer of wealth.

Stützel "clearly defines the kind of informational asymmetry on which his analysis is based by comparing redistributive insider transactions with playing roulette at a casino where the chips are put down after the ball comes to rest, but where only some gamblers have the privilege to know the winning number before they decide on their bets."<sup>61</sup> Thus, unpublished inside information that will have an impact on price when published is an informational advantage with immediate value.

In addition to the fact that stock and claims on stocks such as warrants and options are durable goods and therefore in a "prominent position among the goods moving in response to informational asymmetry"<sup>62</sup>, they are highly price sensitive to company information because they represent "capitalized residual company income."<sup>63</sup>

Stützel makes the assumption that insiders and outsiders are two distinct groups. Insiders will gain as a group at the expense of the outsider group.<sup>64</sup> Schmidt goes one step further specifying that the reaction of investors depends on whether insiders will trade or abstain.<sup>65</sup>

The mere existence of inside information may not influence an individual outsider if he is convinced that no insider trading is taking



place "since he expects to gain and lose about equal amounts in future transactions due to late disclosure, and he may or may not react, depending on the number of transactions he engages in and other factors."<sup>66</sup>

The knowledge that insiders will trade on inside information drastically influences the reactions of investors. Since the individual outsider will expect to lose more than he gains in future transactions he will be willing to "pay less for the share of a given company if inside information and insider trading exist than in a situation with prompt disclosure."<sup>67</sup> All uncertainty (including the possibility of insider dealing) incurs additional cost; expected returns on investments are, therefore, reduced.

Hartmut Schmidt explains the effect of insider trading by comparing the two different positions, i.e. the payoffs of a share that the investor expects in a situation without insider trading as a position with positive expected value for which the position would pay a certain price (position B) as opposed to a position A encompassing all the payoff-effects of inside information and insider trading, i.e. expected losses to outsiders. "Position A has a negative expected value and the investor would 'purchase' it only at a negative price."<sup>68</sup>

Positions A and B are inseparable in markets with inside information and insider trading. The investor protects himself by paying less for AB than he would pay for B and at the time of purchase he will try to make alternative choices (this in all probability would involve an alternative jurisdiction).

The threat of inside information and insider dealing increases transaction costs (*e.g.* wider bid-offer spread), which lead to lower share prices and, thus, to higher cost of capital of the issuing company. In that

line of reasoning, issuers and economic policy makers do have "an incentive to restrict insider trading."<sup>69</sup>

The inference is readily drawn that a higher cost of capital "curtails investment and thus weakens the growth of the economy" thereby decreasing welfare.<sup>1</sup> According to Hartmut Schmidt the reasoning of insider regulation rests primarily on the following assumptions:<sup>70</sup>

1. Market participants are rational and engage in a substantial number of transactions .

2. Insiders possess from time to time undoubtedly valuable unpublished information.

3. Insiders and outsiders are two distinct groups.

4. Investment or consumption alternatives are available that are not affected by insider trading.

5. Outsiders derive no benefits whatsoever from insider trading.

6. Outsiders are needed to clear the market for shares.

7. Real investment in an economy is inversely related to the cost of capital .

The same line of reasoning *mutatis mutandis* will be followed in the analysis of market-maker reactions.

A market-maker, according to H. Schmidt, is a "*dealer who quotes bid and ask throughout the day and who wants to profit from buying at his bid and selling at his ask.*"<sup>71</sup>

Market-makers have a strong incentive to try to straddle the equilibrium price, the price that clears the market. If his quote was above this price, he would accumulate a long position; if it was below he would sell and end up with a short position.

Market-makers, buy and sell securities, hold them for preferably short



periods, profit from this dealing and cause trading losses to outsiders as a group which would not have occurred if there had been no market-maker trading.<sup>72</sup>

The differentiating point between market-makers and insiders is that the former render a service, "the service of immediate execution of investors' orders."<sup>73</sup>

An investor who wants to sell may do so at a bid; in exchange for the difference between the equilibrium price and the bid, without having to wait for a corresponding buy order and to suffer from price fluctuations during the waiting period. Potential buyers can benefit from the service of market-makers by paying the difference between ask and equilibrium price.

This "bid-ask spread" or according to H. Schmidt the *ex ante* "cost of immediacy" may increase transaction costs but can also contribute to the "marketability" or "liquidity" of the shares.<sup>74</sup>

Treynor suggests that assumption 3 should be superseded by 3\* with the following wording: *Insiders, outsiders and market-makers are three distinct groups and all trading goes through market-makers.*<sup>75</sup>

Market-makers normally lose to insiders for two main reasons. Firstly because insiders will trade with them only if, as H. Schmidt puts it, "they anticipate a gross trading gain in excess of the cost of immediacy that they have to incur" and secondly because market-makers do not know whether they deal or not with insiders at the time of the transaction.<sup>76</sup>

The expected reaction of a market-maker is to quote a wider bid-ask spread and only if he is lucky<sup>77</sup> will this solution partly compensate him for the additional risk he has to assume at the expense of outsiders.

Treynor's proposition leads to the conclusion that insider trading increases, because investors react to the additional transaction costs, the



cost of capital which provides an incentive for companies or a challenge for governments to impose insider trading restrictions.<sup>78</sup> A similar conclusion has already been stated in regard to the investor reaction approach.

Amihud and Mendelson point out that the repetitious and additive nature of transaction costs makes them a major determinant of asset prices because in contrast to risk, they never cancel out in a portfolio.<sup>79</sup> Amihud and Mendelson also argue that a firm will voluntarily expend resources to disclose information and restrict insider trading in an effort to avert an increase of the cost of capital.

King and Roell point to the high sensitivity of trading volume to changes of transaction costs and suggest that stock exchanges and their members have a "strong interest in cracking down on insider trading."<sup>80</sup> According to H. Schmidt this is plausible if commission business is profitable, if exchange members are outsiders or market-makers and if assumption 3\* holds.<sup>81</sup>

The major shortcoming of the market-maker approach can be traced in the case of markets organized on the auction principle<sup>82</sup>, where transactions are effected between outsiders and insiders without the intervention of market makers, and, therefore, the market-maker approach "fails to provide a rationale for insider regulation."<sup>83</sup> In this particular case the necessary justification can be provided by the investor reaction approach.

In a market where all trading goes through market-makers it is more difficult<sup>84</sup> to apply the investor reaction approach because outsiders never trade with insiders and it is more difficult to trace individual or group losses to insider information. Here the market-maker approach appears more suitable for rendering an economic foundation.

A recent tendency of national markets is to combine the features of market-makers (financial intermediaries) and auction (mainly in countries organized on the universal bank principle which involves not only services related to loans and savings but also those related to making investments in companies) with a view to meeting the global competition demands.<sup>85</sup>

The reactions of both market-makers and investors determine the effect of insider dealing on the cost of capital. Consequently, the two approaches should be perceived as mutually complementary.

Under the assumptions which provide the theoretical ground for this analysis, market-makers and investors, being the prime victims of insider dealing will react by protecting themselves (assumption 1,3 & 3\*, 4). H. Schmidt reaches the rather questionable conclusion that in these particular cases there is no need for government regulation against insider dealing. The problem, according to the same writer is that the prime victims pass their losses on to society and public companies, the ultimate victims.<sup>86</sup> The question which then arises is whether insider regulation should be better left to companies instead of governmental authorities, in view of the fact that companies have the incentive and they are apparently *"in an excellent position to restrict insider trading."*<sup>87</sup>

The crucial question for a public company is whether the private gain from insider transactions would exceed private costs incurred by the enforcement of these restrictions. If company A imposed a ban on insider trading and incurred the relative cost, "the price of shares would rise, provided that private costs.....are less than the gross private gain, i.e. in this case the effect of of insider trading on the share price multiplied by the number of outstanding shares. Suppose A's programme is disclosed to the market, the share price rises accordingly and the net private gain (G)



results as expected."<sup>88</sup>

Easterbrook supports the view that this is most unlikely to happen because of free riders. If companies of a B type manage to copy successfully the announcement of A-type firms but not the enforcement of insider restrictions they will "gain and take a free ride."<sup>89</sup> In that case both gross private gains and incentive for anti-insider programmes disappear because investors will not be able to distinguish between the two types of companies and they will, therefore, be more reluctant in investing.

H. Schmidt points out that the free rider scenario is what one would expect because of the difficulties and the cost involved in any company's efforts to eliminate insider dealing.<sup>90</sup>

Bad and good transactions (that is to say transactions of insiders where their purpose is not to gain from doubtlessly valuable unpublished information) can not be easily distinguished. Easterbrook argues that managers have the incentive and the ability not to observe any kind of insider restrictions.<sup>91</sup> Even in the absence of free riding, investors can not reasonably expect any insider regulation programme to be fully effective. These arguments point to the direction that "the initiation and enforcement of anti-insider programmes by individual public companies is rather unlikely."<sup>92</sup>

One possible solution is provided by public listing on an exchange and the use of the exchange computers to filter out questionable trades. Even if companies are able to impose penalties as a sanction to insider dealing that may be not severe enough to produce the desirable deterrence. In the case of imprisonment government regulation is needed.<sup>93</sup>

The additional assumptions that underly the argumentation up to this point should be noted:<sup>94</sup>

1. Market participants are rational and engage in a substantial number

of transactions.

2. Insiders possess from time to time doubtlessly valuable unpublished information.

3. Insiders and outsiders are two distinct groups.

3\*. Insiders, outsiders and market-makers are three distinct groups and all trading goes through market-makers.

4. Investment or consumption alternatives are available that are not affected by insider trading.

5. Outsiders derive no benefits whatsoever from insider trading.

6. Outsiders are needed to clear the market for shares.

7. Real investment in an economy is inversely related to the cost of capital.

8. Enforcement of insider trading restrictions is very difficult and costly.

9. Punishment is an efficient method of enforcement and compliance increases with the severity of the penalty.

The validity of assumption 9 has been challenged by empirical studies on U.S. data. Seyhun examined the impact of the Insider Trading Sanctions Act of 1984 which increased considerably civil fine to three times the amount of the profit and the maximum criminal fines in s. 32 of the Securities and Exchange Act from \$10,000 to \$200,000.<sup>95</sup> The number of all open market insider transactions filed by executives (officers, directors, etc.) indicates that the latter have increased their trading activity. Seyhun concludes that now a large volume of insider trading is more likely to be motivated by important non public information and finds, therefore, no observable additional deterrent.

Gupta and Misra studied the effect of the SEC crackdown on takeover



insiders in 1986, which led to the arrests of Levine, Boesky and others.<sup>96</sup> They conclude that insider trading is not a significant contributor to 'pre-announcement price run-ups', comparing price and volume run-up patterns in takeovers before and after May 1986. H. Schmidt correctly remarks that "the evidence presented by Gupta and Misra would also be consistent with the conclusion that insiders were not deterred by the 1986 SEC actions."

A study of the changes in volume and profitability of insider trading that may have been caused by the *Cady, Roberts* decision in November 1961 and the April 1965 *Texas Gulf Sulphur* decision based on insider reports to the SEC, reaches the same conclusion.<sup>97</sup>

The problem with all the findings based on SEC filings is that they are biased toward finding no effect since they 'look only at data that insiders voluntarily disclose'; as Easterbrook points out 'it is unlikely that insiders file reports condemning themselves.'<sup>98</sup>

Gupta and Misra have suggested that the run-up 'could well be an unbiased market response to publicly available information that increases the probability of a takeover.'<sup>99</sup>

Any further analysis on the validity of assumption 9 appears to be beyond the scope of this paper. It will be taken for granted that assumption 9 holds in order to proceed with considering the problem of possible benefits of insider trading to non insiders (i.e. assumption 5).

In an effort to examine the potential benefit of insider trading to non-insiders and to clarify the concept of inside information H. Schmidt makes the distinction between model and event information:<sup>100</sup>

*"Event information is information on observable facts such as progress in the development of a new product on the current level of sales or interest rates. Model information is information on valuation models or on translation models. Models for*

*the valuation of shares usually discount future cash returns to shareholders. Translation models translate event information into the inputs needed by valuation models, e.g. they translate changes in sales or wages into changes of cash return to shareholders."*

It is most probable that executives do have superior translation model information which may be implicitly related, in part, in the regular disclosures of a company but because of its complexity it can not be "fully communicated to outsiders."<sup>101</sup>

In this case executives can trade with outsiders, on this information, and their transactions can have an impact on share prices so as to get them in line with economic reality. As H. Schmidt puts it: "insider trading may eliminate distortion in relative share prices."<sup>102</sup>

At first glance this could be a benefit of insider trading at least on model translation information, but under the condition that the cost, which would ultimately be borne by public companies and society, is smaller than the benefit.

If the cost is higher than the benefit, share price level falls and the cost of capital rises in comparison with a situation where insider trading is restricted and some distortion occurs. In this particular case it can hardly be argued that insider trading on model information should prevail.

In recent years a more cautious approach is adopted by regulators and scholars:<sup>103</sup>

Spectacular and sudden losses to insiders are most likely to produce the strongest investor and market-maker reactions and may even have disruptive effects whereas the excess returns of insider transactions reported to the SEC during the first months after the transaction are on average 1%.<sup>104</sup> In the latter case the process by which the corresponding losses are transferred from the prime victim to the ultimate victim can



probably take care of these losses without any disruptions of market-maker and investor activities and, therefore, a less than proportionate reaction of the prime victim (market-maker or investor) compared with spectacular and sudden losses.<sup>105</sup> If regulation and enforcement focus on insider transactions yielding "sudden and very substantial rates of excess return" as H. Schmidt points out, much of the marginal possible gross gain from regulation can be captured. According to the same commentator such transactions are motivated by undisclosed *event* information. <sup>106</sup>

In addition to the 'undistorted relative share prices' theory on the possible benefits from insider trading to non insiders, there is the 'compensation package' theory which has been sufficiently covered in previous paragraphs.

The above argumentation seems to point to the conclusion that has been stated by Carlton and Fischel who claim that the 'apparent absence of widespread prohibitions of insider trading in employment contracts and corporate charters and the existence of common law rules permitting insider trading create a strong presumption that the practice may be beneficial in some circumstances.'<sup>107</sup>

H. Schmidt remarks with felicity that this proposition although it is not as convincing as it may appear at first glance, should not be neglected in the regulatory debate.<sup>108</sup> At this point he compares the German insider regulation (i.e. the legislation of his jurisdiction) with insider restrictions in the United Kingdom and in Ireland.

Whereas in the U.K. and in Ireland all companies listed on the Stock Exchange have been voluntarily accepting insider measures beyond what is legally required and relevant private restrictions are also included in the City Code on Takeovers and Mergers and in the Granville Market General Undertaking, in Germany the matter was, until recently, dealt

with in employment contracts.<sup>109</sup> It is also noteworthy that the German insider rules were not tied into a listing package that a company must accept or reject as a whole, but it might at any time decide to discontinue the insider restrictions without affecting its status as a listed company. However, no such motion has ever been presented at a general meeting and this can be an indication as to the ultimate 'net cost'<sup>110</sup> to outsiders.

The only final conclusion of universal application that seems inevitable is that there is no economic foundation for *mandatory* insider regulation. On the other hand there is no reliable evidence so far to support the possibly beneficial results of noncompulsory insider regulation.

#### **d. The American Experience (Related Legal Theories)**

The United States enjoys the reputation of having the most comprehensive and expansive system of securities regulation in the world.<sup>111</sup> Abuses in securities transactions that were considered instrumental in precipitating the stock market crash of 1929 necessitated efforts to control, among others, insider trading transactions. In the early 1930s the common law prohibited fraudulent transactions in securities markets. Prior to the Depression, insider trading actions were uncommon.<sup>112</sup> In 1933, Congress passed the Securities Act, followed in 1934 by the Securities Exchange Act.<sup>113</sup> The 1934 Act, whose goals, as President Roosevelt noted, were to restore honesty and public confidence in the securities market,<sup>114</sup> addressed insider trading indirectly through section 16(b) strict liability and through section 10(b) liability for fraud.<sup>115</sup> An analysis of the United States regulation on Insider Trading provides,



according to one commentator, helpful insights for analyzing the EC Directive.<sup>116</sup>

The principal source of federal regulation of insider dealing in the United States is Rule 10b-5 which was promulgated pursuant to the 1934 Act. In addition to the "broad sweep"<sup>117</sup> proscription of Rule 10b-5, Rule 14e-3 (promulgated pursuant to the 1934 Act) and section 16(b) of the 1934 Act, also regulate insider trading.

*Rule 14e-3* attempts to restrict insider trading in the context of tender offers by prohibiting anyone who possesses information relating to a tender offer from trading in the target company securities if (1)the bidder has taken a substantial step toward commencement of a tender offer (a US practice of offering securities to the public by inviting them to tender a price; the securities are then sold to the highest bidder); (2)the person possessing the information knows or has reason to know that the information came from the bidder or target company; and (3)the person possessing the information knows or has reason to know that the information is non-public. In a Rule 14e-3 action there is no requirement that a fiduciary relationship exist between the trader or tipper and the target company's shareholders.<sup>118</sup> As it will be shown, Rule 14e-3 was the response<sup>119</sup> of the Securities and Exchange Commission (hereinafter SEC) to the strict statutory construction of Rule 10b-5 in the *Chiarella v. United States* <sup>120</sup> case.

*Section 16(b)* of the 1934 Act prohibits "*short-swing*" profits by insiders regardless of the nature of the information utilized to make the trade. The objective of this proscription is to prevent insider trading on the part of designated insiders: officers, directors and major shareholders. Steven R. Salbu supports that this approach creates an "irrebuttable presumption of unfair use of information when insiders turn a fast profit

by either the purchase or sale of securities."<sup>121</sup> Under section 16(b) profits are recoverable "irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased.....for a period exceeding six months."<sup>122</sup> Only a corporation or a shareholder suing derivatively may bring a section 16(b) action since the SEC lacks authority to enforce section 16(b).

*Rule 10b-5*, as already mentioned, constitutes the more important and more commonly used<sup>123</sup> proscription of insider trading for both the SEC and private investors. It is a general provision prohibiting "fraud or deceit upon any person, in connection with the purchase or sale of any security." The rule states:<sup>124</sup>

*"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,*

*(a) to employ any device, scheme, or artifice to defraud,*

*(b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or*

*(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."*

In the absence of a specific reference to insider trading, courts have to construe this rule broadly so as to prohibit insider trading when in possession of material, non-public information. This is one of the reasons why the definition of insider trading liability has mainly developed through case law.<sup>125</sup>

The enforcement of Rule 10b-5 has also required substantial judicial interpretation of the definition of fraud because trading is typically made



"in the absence of express statements in which misrepresentation can be found."<sup>126</sup> It was made necessary, therefore, "to establish the conditions under which fraud can be inferred from silent trading."<sup>127</sup>

The major strength of Rule 10b-5 is its breadth which gave United States courts the possibility of applying it to insider trading violations. In 1946 the Federal District Court for the Eastern District of Pennsylvania<sup>128</sup> created private causes of action (*i.e.* mainly damages) for insider trading. More recently the Supreme Court has upheld the validity of these private claims.<sup>129</sup> United States Courts have expanded the scope of the Rule to reach non-insiders such as tippees and, in some situations lawyers and accountants of corporations.<sup>130</sup> Amy E. Stutz remarks that the weakness of Rule 10b-5 is found in its strength, in view of the fact that United States Courts have manipulated and expanded the reach of Rule 10b-5 substantially on an *ad hoc* basis.<sup>131</sup>

The Securities and Exchange Commission construed the antifraud provisions of the 1934 Act broadly in *In re Cady, Roberts & Co.*<sup>132</sup> The Commission held that Rule 10b-5 can apply to corporate outsiders who trade on information unavailable to the public. The so called "*disclose or abstain rule*" originates in this case which, according to Reinier Kraakman is the best known and most ambiguous "sentence in the *corpus* of insider trading case law."<sup>133</sup> In the Commission's words the rationale for invoking Rule 10b-5 offered by *Cady, Roberts & Co.* (the first SEC decision to address insider trading on the open market) rested on two principal elements:<sup>134</sup>

*'First, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose, and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with*

*whom he is dealing.*<sup>135</sup>

The "disclose or abstain rule" requires anyone possessing material, non-public information about a corporation to refrain from trading in the securities of that corporation or to disclose the information to the market. The Second Circuit supported the Commission in its expansive reading of Rule 10b-5 in *SEC v. Texas Gulf Sulphur Co.*<sup>136</sup>, stating that anyone in possession of inside information is required either to disclose the information publicly or to refrain from trading in relevant securities. In the opinion of Salbu *Texas Gulf Sulphur* contains "the most liberal interpretation of the 1934 Act to date, evincing a philosophy that any trading on material information not available to the public is inherently unfair and destructive to the efficiency of securities markets."<sup>137</sup>

The theoretical system that underlies the *Cady* and the *Texas Gulf Sulphur* cases has been christened "*Equal Access Theory*" by Kraakman who supports that the main doctrinal advantage of this theory is the creation of a "simple rule against exploiting almost all informational disparities that are popularly perceived to give an unfair trading advantage."<sup>138</sup> According to the same commentator the theory could also incriminate tippees and financial printers for violating their obligations to disclose or abstain regardless of whether the information originates outside the company, since the "essence of wrongdoing lies in exploiting an informational advantage over other traders."<sup>139</sup>

The *Equal Access Theory* and the "wholesale allocation of trading rights in non-public information to investors at large, except where informed traders earn an exclusive right to private information the hard way, through their own research and analysis"<sup>140</sup>, was at odds with the Supreme Court's own effort during the seventies to delimit liability under Rule 10b-5. The first insider trading case in the Supreme Court signaled



the end of the "Expansion Era"<sup>141</sup> of judicial interpretation by rejecting the equal access theory and restricting "the previously wide net of liability derived from *Texas Gulf Sulphur*. It was in the *Chiarella v. United States*<sup>142</sup> case where the United States Supreme Court reversed the conviction of a financial printer who deciphered the code names of target companies in a tender offer and made a profit of \$30,000. The Court held that the duty to disclose under Rule 10b-5 "does not arise from the mere possession of non-public market information,"<sup>143</sup> and that there is a duty to disclose only if a fiduciary relationship exists between the parties to the transaction.<sup>144</sup> The Court did not find this relationship existing between *Chiarella* and the sellers of the target company stock.<sup>145</sup> In response to *Chiarella*'s limitation of liability under Rule 10b-5, the SEC promulgated Rule 14e-3 pursuant to section 14(e) of the 1934 Act, prohibiting both insiders and outsiders from trading on material, non-public information relating to corporate tender offers. The extent to which Rule 14e-3 augments the "post-*Chiarella* efficacy of insider trading laws is still uncertain."<sup>146</sup> The issue is currently being addressed by the Second Circuit in *United States v. Chestman*.<sup>147</sup>

Tippee liability is similarly limited. It is based on a fiduciary duty of the insider to the corporation's shareholders, a duty which is breached by the insider divulging such information to the tippee.<sup>148</sup> In *Dirks v. SEC*,<sup>149</sup> Dirks, a securities analyst received a tip from a former officer of Equity Funding of America (EFA) that the company's assets were overstated. Dirks, the tippee, disclosed the information to his clients. The Supreme Court held that the former EFA officer -the tipper- did not breach the duty to disclose because he did not seek a personal gain and outlined the scope of this duty:

*The test is whether the insider personally will benefit, directly or indirectly,*

*from this disclosure. Absent some personal gain, there has been no breach of duty to stockbrokers. And absent a breach by the insider, there is no derivative breach [by the tippee].*<sup>150</sup>

The Court has not defined the scope of this benefit requirement. Lower courts, however, have required the benefit to be a personal one which enriches the insider monetarily.<sup>151</sup> Finally, in order to find the tippee liable for trading on such information conveyed by the insider, the tippee must have actual or constructive knowledge that the insider breached his fiduciary duty by disclosing such information.<sup>152</sup>

The "Fiduciary Duty Theory"<sup>153</sup>, as the reasonings in the *Chiarella* and the *Dirks* cases have been named by Kraakman, could not cover the "quasi-insider",<sup>154</sup> who does not fit the traditional corporation law notion of a person who owes a fiduciary duty to the shareholders of a corporation.<sup>155</sup> Lower courts have developed the *misappropriation theory*<sup>156</sup> in such circumstances. Although the United States Court of Appeals for the Second Circuit upheld the misappropriation theory,<sup>157</sup> the United States Supreme Court has not resolved the issue.<sup>158</sup> Chief Justice Burger first introduced the misappropriation theory in his dissent in *Chiarella*.<sup>159</sup> Under this theory, a person who has misappropriated, or "stolen", non-public information has an absolute duty to disclose the information or abstain from trading. Consequently, liability is extended to persons possessing material non-public information who use the information in violation of a duty owed to someone other than the shareholders of the corporation whose securities were traded.<sup>160</sup> Such a person has in effect stolen information in the context of a relationship of trust and confidence between the trader and the source of the information. This requisite relationship typically exists between an employee and employer, or an investment advisor and a client.<sup>161</sup>



The United States Court of Appeals Second Circuit in *United States v. Newman*<sup>162</sup> adopted this theory in holding that the use of confidential information by an employee breaches the employee's fiduciary duty to the employer and therefore constitutes fraud, triggering Rule 10b-5.<sup>163</sup>

In *Carpenter v. United States*,<sup>164</sup> the Supreme Court examined trading by R. Foster Winans, author of the "Heard on the Street" column of the *Wall Street Journal*, and alleged tippees employed by Kidder Peabody. Winans and the tippees were accused of using information contained in articles for future publication in Winans' column.<sup>165</sup> The Court reached a deadlock of 4-4 on the issues of insider trading and misappropriation, affirming the lower court's conviction on separate issues of mail fraud. Salbu<sup>166</sup> claims that, at present, trades made by insiders using publicly unavailable information are prohibited under American Law only with proof that the insider traded on material non-public information in violation of a fiduciary duty.

A considerable amount of criticism has been leveled against the misappropriation theory. Langevoort characterizes it as "awkward at best, essentially federalizing the law of corporate intellectual property and employee responsibility for securities law purposes without any real justification, except in terms of result -a means of permitting the SEC to reach what intuitively are abusive trading practices that were thought to be unreachable under the post-*Chiarella* fraud on the marketplace theory."<sup>167</sup>

Kraakman examines the question whether the misappropriation theory's extended ban will survive the scrutiny of the Supreme Court.<sup>168</sup> He supposes that the theory's chances of survival may have improved since the enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). "Without making any explicit

endorsements, ITSFEA seems to bolster the misappropriation theory indirectly by including a provision that permits contemporaneous public traders to bring a private action against market insiders even when they would lack standing to sue under the misappropriation case law."<sup>169</sup>

The developments in the American insider trading doctrine that the past decade has witnessed should not be simply perceived as an extended discussion of the legal concept of fraud which "the Supreme Court has identified as the operative core of Rule 10b-5."<sup>170</sup> The fact that the equal access theory has been superseded by the fiduciary duty and misappropriation theories reveals a choice against a "market-centered response to insider trading that is based on global assertions about the fairness or efficiency of informational disparities in the market."<sup>171</sup> The fiduciary duty and misappropriation theories already reach most conduct that would be condemned by the equal access theory or by a position-based definition of regulated insiders, such as the formulation adopted by the European Community Directive which shifts the emphasis back to the securities market as will be shown in the analysis of the European approach (under *e*). The main problem that doctrinal concerns may pose is that they could distract law-makers from the real issue of "how best to allocate trading rights over the range of individual circumstances in which trading information is produced."<sup>172</sup>

It has been made clear, so far, that the United States Congress expanded its regulation of the United States securities markets through the years to meet changes in "marketplace" trading.<sup>173</sup> Section 10(b) was originally intended only as a general prohibition of deceitful or manipulative practices.<sup>174</sup> As Amy E. Stutz points out: 'when section 10(b) was enacted in 1934, individuals dominated trading.' Courts interpreted broadly the language of both section 10(b) and Rule 10b-5 in order to



provide a legal basis for holding tippees as well as primary insiders guilty of insider trading and meet the changing needs of the market. The broad scope and flexibility of these rules have been proved to be their weakness and make them susceptible to judicial abuse. The latter possibility becomes particularly obvious in the light of the *ad hoc* (even piecemeal) basis on which courts usually confront them.

The Supreme Court affirmed, recently the misappropriation theory in *United States v O'Hagan* (No 96-842, 1997 US LEXIS 4033 1997). O'Hagan was a partner in a law firm retained by Grand Metropolitan plc as a local counsel in connection with their proposed takeover bid for Pillsbury. Although not directly involved in the transaction, Mr O'Hagan nevertheless obtained non-public information from a fellow partner who was and bought both stock and call options in Pillsbury. On the announcement of the tender offer, the Pillsbury stock rose and O'Hagan realised a profit of \$4.3m. SEC noticed Mr O'Hagan's trading activity and he was subsequently convicted on 57 counts and sentenced to 41 months' imprisonment on the basis of his violation of s.10(b), as construed under the misappropriation theory.

The Court of Appeals of the 8th Circuit reversed all of the convictions on a majority decision, holding that criminal liability under s.10(b) could not rest on the misappropriation theory. This decision left the law on insider dealing in a shambles.<sup>175</sup> This was the position faced by the Supreme Court the Majority of whom in effect restored the decision of the original District Court by upholding the misappropriation theory as complementary to the classical theory. Both theories, according to the decision are bases for conviction under r. 10b-5.

e. **The European Approach.** *The fiduciary implication or the journey from the corporate to the securities market approach.*

The American experience on securities regulation can offer two undeniably useful lessons to the EC legislator: A "broad, flexible approach to the regulation of insider trading"<sup>176</sup> is desirable but a "clear definition of terms"<sup>177</sup> is nonetheless necessary to prevent judicial abuse. As it will be shown later the relative EC Directive has (according to the majority of commentators) accomplished the aforementioned objectives whereas its main shortcomings rest on the sector of enforcement and sanctions.

A study of the *legal* theory that underlies the Insider Regulation in Europe should not be simply perceived either as an attempt to comprehend the *causes* that led most European countries to promulgate laws against the abusive use of privileged insider information or as a discussion of "the merits and the demerits of insiders' actions".<sup>178</sup> As Alain Viandier remarks, most specialists, when they try to highlight the rational bases of the regulation, are satisfied with catch words such as '*equality, loyalty and efficiency*' before proceeding with the examination of the incriminating conditions.<sup>179</sup>

The study of P. Lascoumes on 'the interests protected by the new federal law on insider trading (art 161 Of the Swiss penal code)<sup>180</sup>, which is in line with R. Ihering and the Tübingen School of '*Interessenjurisprudenz*'<sup>181</sup>, provides an ideal point of departure for reflection on the European theoretical justification of insider dealing regulation. According to Lascoumes' study, the regulation on insider trading is aiming at the protection of the interests of "the company issuing shares whose price may be affected by privileged information and market information."<sup>182</sup> According to Viandier<sup>183</sup> there is a 'disparity between the



advertized basis and the actual setup, as if the basis had a merely evocative value and no real working quality at all' when it comes to examining the regulations.

The traditional argument *pro* regulation, focusing on the confidence of the investing public has gained new force as a result of the public attention which the relatively recent insider scandals have increased.<sup>184</sup> In most of the European securities and capital market regulation systems the demands for *fairness* and for a *level playing field* are winning through.<sup>185</sup> Professor Hopt claims that 'from a legal policy view, the balance of the scale - taking into account Europe 1992 and the desirability of *well-functioning international financial markets* - is *pro* regulation of insider dealing and, in that case, *pro* European harmonization of insider law.'<sup>186</sup>

The above 'dualist presentation', i.e. the efforts to justify the insider regulation either by the necessity to protect companies or by the demand to protect the market has been branded by Viandier as 'undoubtedly simplistic'. In the latter's opinion the concept of information as property should not be totally ignored.

The evolution of the, otherwise lacking the benefit of strong historical antecedents in national *fora*<sup>187</sup>, legal theory of insider regulation in Europe will be followed along three successive points: the protection of the company (inextricably linked to the fiduciary theory), the protection of the market and, finally, the protection of information.<sup>188</sup>

#### i) Protection of the Company.

In his study on the development of UK insider law and the possible impact of the EC Insider Dealing Directive on the British legislation, P. L. Davies<sup>189</sup> exposes the uncertainty as to 'whether the purpose of the insider

trading laws was to strengthen the controls already imposed by equity on certain relationships in the corporate sphere because of their fiduciary character, or whether the purpose was not rather to regulate relationships in the securities markets, irrespective of whether these had previously been characterized by the common law as having a fiduciary character'.<sup>190</sup>

In the company law or fiduciary model of insider trading laws, the paradigm case is that of the director of a company who trades in the shares of the company, making abusive use of the privileged information he has obtained by reason of his fiduciary relationship with the company. The main constituting elements of the illegal act are the deliberate exploitation of unpublished price-sensitive information obtained through a privileged relationship and the purpose to make a profit or avoid a loss by dealing in securities the price of which would be substantially influenced by the public disclosure of this information.<sup>191</sup>

The French Commission of Bourse Operations (COB) stated as early as 1976 that 'the company managers are mandated by the shareholders, they are accountable to them for the future of the firm, and the use for any personal reasons of important information - which is an element of common patrimony - can only be seen as disloyal behaviour.'<sup>192</sup> Viandier observes that most of the relative legal texts in Europe 'bear the trace of influence of the fiduciary explanation', and the latter is more than obvious in preparatory documents. In the project-draft for art 161 of the Swiss penal code there is also a fiduciary duty theoretical basis. According to the quotation of Viandier the document presents the insider as a person 'violating his duties towards the company (and) betraying the relationship of trust with a firm.'<sup>193</sup> This is also clear in the early discussions in the UK<sup>194</sup>. The Jenkins Committee<sup>195</sup>, in an attempt not strictly within the fiduciary duty approach, wished to provide a civil remedy for the other



party who traded with the insider, not only had to confront the traditional reluctance of English company law to recognize that directors owed fiduciary duties to individual shareholders but also with the basic rule in English Law of *Caveat Emptor*. According to the analysis of Davies it was doubtful whether the Committee saw this proposal as simply extending to a new range of beneficiaries the fiduciary duties traditionally owed by directors to their companies or whether they saw it as a first step towards the general regulation of relations between and among market traders.<sup>196</sup> The civil sanctions proposals came under attack by the JUSTICE Committee which argued that, in the case of Stock Exchange trading, where the matching of any particular vendor with any particular purchaser was made entirely by chance, 'there is no obvious justification for giving a vendor who happens to have sold shares to an insider a remedy which is not available to the vendors who have sold similar shares at the same time and at the same price to outsiders'.<sup>197</sup> Perhaps because of this attack the proposals were never enacted.

In *Chase Manhattan Equities Ltd v Goodman*<sup>198</sup> Knox J interpreted section 8(3) of the Company Securities (Insider Dealing) Act 1985, which provides that no transaction is void or voidable by reason only that it was entered into in contravention of sec. 1 of the Act, making the remark that:

*"if the premise that Parliament by enacting sec. 8(3) provided that no civil consequences should flow from infringements of the 1985 Act then indeed would be a strong indication that the court should not prevent the sale agreement from being completed. It does not however necessarily follow that because Parliament has said that no transaction is void or voidable by reason only of an infringement of sec. 1, therefore such a transaction is not to be regarded as illegal. The illegality is there by operation of law and the provisions of sec. 8(3) prevent what would otherwise be the consequences that transactions on the Stock Exchange would need to be unwound."*<sup>199</sup>

According to Knox J the purpose of sec. 8(3) is to protect the workings of the Stock Exchange and prevent completed transactions from being unwound. On the other hand, Knox J points out that where Parliament desires an enactment imposing criminal penalties not to have consequences in civil law it does so in terms. Finally he concludes:

*"The problem has to be solved by an identification of the purpose of Parliament in choosing the words actually used in sec. 8(3) rather than providing for transactions not to be enforceable in the stated circumstances. Unenforceable and voidable contracts are different in many respects and Parliament must be taken to have appreciated this. A principal factor which the Parliament must have had in view in enacting sec. 8(3), inter alia, was to prevent the disruption of completed Stock Exchange transactions. The argument in favour of the parliamentary intention having been wider resides principally in the fact that sec. 8(3), inter alia, prevents an agreement to sell securities from being voidable solely on the ground of infringements of the Act and that is not limited to completed transactions. Nevertheless I conclude that within the narrow field of refusing to lend the court's assistance at the suit of a person guilty of criminal conduct, there remains room for the application of the ex turpi causa doctrine. I take into account that the machinery of the Stock Exchange has not operated in relation to the sale agreement and that only the parties to the original dealing which is tainted by illegality [emphasis added] are involved. The sale agreement is therefore in my view unenforceable. Since the body with the legal title to the shares which were involved in the illegality is before the court and submits to do what is directed I take the view that I should make the sought in para. 1(A) of the relief prayed for in the statement of claim subject to altering the expression therein 'unlawful contrary to' to 'unenforceable because it was tainted in its creation by an infringement of'. No question of damages in my judgement arises and the counterclaims will be dismissed."*<sup>200</sup>



In France there has been an effort to deepen the fiduciary approach by obliging the perpetrator of insider dealing to pay back to the company the profits made on inside information and by imposing penalties. This was the case according to the former wording of the French Ordinance of 28 September 1967.<sup>201</sup> This effort was very soon abandoned,<sup>202</sup> and the sanction of paying back profits was replaced by *post facto* criminal penalties for persons effecting transactions on the basis of privileged information. It should be noted that the scope of the Ordinance is not confined to persons holding a fiduciary relationship with the company but is directed past the company managers at those people, whatever their relationship with the company, 'who while exercising their profession or their function hold privileged information.'<sup>203</sup>

The French regulation is rather the rule than the exception at least among EC Member States' regulations. Many such regulations similarly adopt an insider definition which goes beyond fiduciary relationships.<sup>204</sup> The English legislators took the view that the definition of 'insider' should be wide, so as to include not merely directors but also employees of the company and 'other persons having access, in the course of their employment, business or profession, to confidential information relating to the company.'<sup>205</sup> Davies argues that in the case of British legislation:

*'rather the extension of the list of people brought within the insider dealing prohibition resulted from, not an abandonment of the fiduciary theory, but rather from a more sophisticated application of it, in particular from a recognition that circumstances can arise in which people other than directors owe fiduciary duties to the company. The focus was still on the insider/company relationship; it had not been transferred to the relationship between the insider and other traders.'*<sup>206</sup>

This is a justified criticism as regards the theories underlying British insider dealing statutes. In the Company Securities (Insider Dealing) Act

1985 the incrimination for insider trading concerns the managers, the persons holding the information by virtue of being connected with the company, those planning a takeover and the public servant,<sup>207</sup> whereas the wording of the Belgian counterpart embraces all those who know 'through function or profession' information that might noticeably influence the value of securities.<sup>208</sup> The EC harmonization effort in the Insider Dealing directive also distances itself from the fiduciary duty theory and defines as insider:

*'any person who by virtue of his membership in the administrative, managerial or supervisory bodies of a company, or because he has access to such information in the course of his employment, profession or duties.'*<sup>209</sup>

Viandier remarks that in the regulation studied there is no (or, better, there is no more) provision for repayment of profits and claims that this weakens the fiduciary explanation.<sup>210</sup> In other words, if the emphasis was placed on the prediction of the company interests, 'how are we to understand that any damages incurred are not repaired forthwith?'<sup>211</sup>

Farrar supports that a possible recovery by the company would be a 'windfall' on the grounds that the company has not been harmed by the transactions<sup>212</sup> and this is probably the idea which underlies insider regulations in most Community countries.

The role that the fiduciary implication can play in current European legislation seems purely that of a theoretical ruler. It is no longer the case that the line must be drawn between fiduciaries and non-fiduciaries but, without any illusions of having reached a definite conclusion, between the 'chance insider' and the insider through 'profession or function.' <sup>213</sup>



## ii) Protection of the Market.

The focus of attention of European insider legislation, unlike its American counterpart (at least as regards case law) has moved from the interests of the company to the protection of the *market* and the confidence of investors which is inextricably linked to the smooth operation of the market.

The market efficiency arguments and the concept of market egalitarianism (according to the Americans) or equity (according to the British) are reexamined by Farrar<sup>214</sup> as a possible justification for insider regulation. The rapid assimilation of all available market information about a company and the reflection of that information into the share price, 'enables resources to be sufficiently allocated', and contributes, therefore, to the creation of an efficient stock market.<sup>215</sup> On the other hand, the law should try to ensure that all investors (or future investors) are placed on an equal footing. These are in simple terms the two ideas which justify the safeguarding of the market: The efficiency of operating and the equality of operators.<sup>216</sup>

In the preparatory stage for the drafting of the Insider Dealing Directive competence was shared between the Commission's Directorate-General XV for Financial Institutions and Taxation and the Directorate-General III which is in charge of company law harmonization. The fact that responsibility remained finally with DG-XV 'predetermined in a way the abolition of a merely corporate law approach to the insider problem' and the selection of a market-oriented solution as K. Hopt observes.<sup>217</sup>

The theoretical foundation of the Directive<sup>218</sup> for rendering insider dealing illegal is the view that insider dealing undermines the confidence which investors should be able to have in the market.<sup>219</sup> For an effective market in securities, according to the Preamble, every measure should be

taken to ensure that the market runs smoothly and that, to a large extent, depends on investor confidence. The arguments and the conclusions of economic theory and research seem to have had only some vague influence on the justifications presented in the Preamble of the Directive.

The Directive should be studied in the context of the general EC ideology on stock-market transactions which is embedded in the Commission Recommendation of 25 July 1977 concerning a European code of conduct relating to transactions in transferable securities (77/534/EEC). This code contains principles relating to the proper use of price sensitive information and its objective is to establish standards of ethical behaviour throughout the Community, to promote the effective functioning of securities markets and to safeguard the public interest. On insider dealing the code stated:

*'Any person who comes into possession of information, in exercising his profession or carrying out his duties, which is not public and which relates to a company or to the market in its securities or to any event of general interest to the market, which is price sensitive, should refrain from carrying out, directly or indirectly any transaction in which such information is used, and should refrain from giving the information to another person so that he may profit from it before the information becomes public.'*

The features that differentiate the approach of the Directive from the previous approach of the existing Member States insider regulations stem from the definition of insider and the definition of information. The first thing to note is that the requirement of confidentiality has gone. Information must just be precise, non-public and price sensitive. Secondly, and more importantly, the information need not be acquired by virtue of a relationship *with the company*. As Davies concludes:

*'Obviously, issuers of securities do benefit indirectly if the markets in which*



*their securities are traded are 'clean', but it might be thought that the main purpose of insider dealing laws is not to prevent companies being overreached by fiduciaries.'*<sup>220</sup>

The influence of the finality of market protection is a fact in many European insider regulations (EU and non-EU). The French equality theory, an improved version of the American equal access theory, prohibits all insider transactions that infringe upon either market integrity or the *égalité idéale* (ideal equality) of investors.<sup>221</sup> Thus, French law moves one step beyond U.S. law and the equal access theory, to address explicitly the entire market place, not merely shareholders of a particular issuer. Some commentators even perceive the French approach as part of the democratic tradition of the country,<sup>222</sup> or remark that:

*'La volonté de moraliser le marché boursier répond à une préoccupation, sinon à une hantise aussi ancienne que l' institution de la Bourse elle-même.'*<sup>223</sup> ('The will to moralize the financial markets corresponds to a preoccupation, if not an obsessive fear, as old as the Stock Exchange itself.'<sup>224</sup>)

According to the Belgian law definition of privileged information this is not any information, but information liable to have an influence on stock-exchange prices.<sup>225</sup> The law of 9 March 1989 refers to information 'which, if it was made public, would be, due to its exactitude and certainty, such as to influence noticeably the value of securities quoted on the official listing.'<sup>226</sup>

In British law there has been an ambiguity between the goal of the protection of companies against abuse by fiduciaries and quasi-fiduciaries and the goal of market protection.<sup>227</sup> The definition of inside information as 'unpublished price-sensitive information' is indicative of market protection tendencies and, as Davies succinctly puts it, 'the EC Directive is merely pushing British law down a road it has already shown considerable

willingness to tread.'<sup>228</sup>

The Swiss penal code (Art 161) follows the EC tendencies by requiring information to be liable to have a noticeable influence on the price.<sup>229</sup>

It should be stressed that the broader definition of information and, perhaps, the most market-oriented one can be found in the Convention on Insider Trading of the Council of Europe.<sup>230</sup> The definition of the Convention is broader than the ones of the English Company Securities (Insider Dealing) Act 1985 [s.10(a)] and the EC Directive in two respects:<sup>231</sup> First, it contains no requirement of '*specificity*'. According to both the U.K. Act and the Directive, as well as the laws of other Member States, the information must be specific, that is, have a degree of certainty and refer to specific matters or be of sufficiently precise and certain character. Secondly, the Convention refers to information which if it were disclosed would be likely to have an effect on the 'stock market', in contrast with most Member State regulations which follow to a larger or a lesser extent the U.K. model and require information to have a substantial effect on the price of securities in question if made public.

The main weakness of the market protection theoretical basis is that it confines protection to publicly recognized investment security markets.<sup>232</sup> The EC Directive envisages the possibility of extending the regulation to operations performed 'outside the market' despite the reference to the interests of the market in the 'recitals'. The reasons for limiting regulations to 'controlled' markets are easy to understand. Listing requirements and investigation possibilities are among the most prominent. But, as Viandier animadverts, the administrative capacity is neither a criterion nor a condition but rather a quality for the existence of the market.<sup>233</sup> The market-protection theory is not discredited by examining its weaknesses, but rather the realization of its inefficiencies is



an incitement to further analysis of information in its own right.

### iii) Protection of Information (an alternative Market Regime)

Information as immaterial property can be the object of rights, it can be appropriated, usurped and protected. Misappropriation or usurpation of information can 'give rise to civil, even penal, sanctions as in the case of the professional secret or the industrial secret.'<sup>234</sup>

The idea of conceiving information as a '*patrimonial*' value, a property, has attracted attention in the *Carpenter* case<sup>235</sup> in the context of the application of the mail and fraud statutes. The idea is present in the reports of the French Bourse Operations Commission (COB) for 1976<sup>236</sup>, where the standpoint that information is a common patrimonial as well as a corporate element is adopted.<sup>237</sup>

The special nature of information and the realization that it is not 'the professions, the functions or some kind of fiduciary duty that designates [persons] as insiders; it is more simply the nature of information they hold.'<sup>238</sup> The stock-exchange information is a property only to be used collectively.<sup>239</sup> The (of common notoriety) alternatives are to refrain from playing or to disclose.

In the (British) DTI consultative document on the implementation of the EC Directive it is stressed that 'as one of the objectives of the law is to prevent the misuse of inside information it is important that the definition of insider cover *all* those who are likely to have insider information.'<sup>240</sup> This possibility is quickly rejected by Davies because the enactment of such as proposition 'could cause damaging uncertainty in the markets, as individuals attempted to identify whether or not they were covered.'<sup>241</sup> Davies rightly argues that the uncertainty that this proposal might generate would not be productive of any greater uncertainty than

the current (British) rules.<sup>242</sup>

The relaxing of the requirement of confidentiality of information and of the relationship of the insider with the company that the EC Directive has achieved make more important the questions of whether the information is price sensitive and, especially, whether it is public.

The nature of information will be critical for the incrimination of tippees. The latter, that is, must be aware of the sensitive nature of the information communicated. The special nature of information basis will enable the outlawing of insider trading whatever the place of operation is, in or outside the market, overcoming, thus, the weakness of the strict market-protection approach and demonstrating that 'the market, if it simplifies prohibition by setting up a practical structure, has no virtue of its own.'<sup>243</sup>

Unlike the direction that the American courts and legislator have taken, the evolution of insider regulation on an EC level has followed in rough terms similar stages. The strictly corporate-company protection approach embedded in the fiduciary duty theory, which favoured a mild regulation and perpetuated inelegant incoherence in the insider regulation environment,<sup>244</sup> has been superseded by the trend towards market protection.

In recent years the role of the notion of protected information is becoming increasingly apparent in regulation initiatives.<sup>245</sup> The future moves will be most probably made in the direction of regulating privileged information.



## NOTES

<sup>1</sup> Brenda Hannigan, *Insider Dealing*, KLUWER 1988

<sup>2</sup> Manne, *Insider Trading and the Stock Market*, 1966

<sup>3</sup> Leo Herzel & Leo Katz, "Insider Trading: Who Loses?", (1987) 165 *Lloyds Bank Review* 15

<sup>4</sup> Hannigan, *supra* note 1

<sup>5</sup> Leo Herzel & Leo Katz, *supra* note 3

<sup>6</sup> Hannigan, *supra* note 1

<sup>7</sup> Stone, Fashioning a Lid for Pandora's Box (1970) *Securities L Review* 205, cited by Hannigan *supra* note 1

<sup>8</sup> Leo Herzel & Leo Katz, *supra* note 3

<sup>9</sup> 248 N.E. 2d 910 (1969)(N.Y. Court of Appeals)

<sup>10</sup> Scott, Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy, 9 *J Leg Studies* 801 (1980), cited by Hannigan *supra* note 1

<sup>11</sup> Hannigan, *supra* note 1

<sup>12</sup> *Financial services in the United Kingdom*, Cmnd 9432, para 3.1.; *The Conduct of Company Directors*, Cmnd 7037, paras 22-23; *Company Law Reform*, Cmnd 5391, para 15, cited by Hannigan *supra* note 1

<sup>13</sup> *Financial Services in the U.K.*, Cmnd 9432, para 3.1. *The Fraud Trials Committee Report (The Roskill Report)*, para 1.

<sup>14</sup> On "Black Monday", 19 October 1987, the Dow Jones industrial average closed 508 points down on the day, a fall of 23%, almost twice the size of the worst one day fall in the Great Crash of 1929. London showed a fall of 250 points on the FT-SE 100, wiping £50.6 billion of the value of shares. "One Week that shook the World", *The Independent*, 24 October 1987. cited by Hannigan *supra* note 1

<sup>15</sup> Hannigan, *supra* note 1

<sup>16</sup> *idem*.

<sup>17</sup> Manne, *supra* note 2

<sup>18</sup> Hannigan, *supra* note 1

<sup>19</sup> Manne, *supra* note 2, cited by Hannigan, *supra* note 1

<sup>20</sup> Gilson & Kraakman, The Mechanisms of Market Efficiency 70 *Va L Review* 549 (1984) cited by Hannigan, *supra* note 1

<sup>21</sup> Hannigan, *supra* note 1 where cited: Hetherington, When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights 8 *Hofstra L Review* 183 at 223 (1979); Farrar & Russel, *The Impact of Institutional Investment on Company Law* (1984)

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5 *Co Law* 107.

<sup>22</sup> Hannigan, *supra* note 1, Carlton & Fischel, *The Regulation of Insider Trading*, 35 *Stan L Rev* 857 (1983).

<sup>23</sup> cited by Hannigan *supra* note 1, Schotland, *Unsafe at Any Price, A Reply to Manne, Insider Trading and the Stock Market*, 53 *Va L Rev* 1425 (1967)

<sup>24</sup> Manne, *supra* note 2

<sup>25</sup> Herzel & Katz, *supra* note 3

<sup>26</sup> Manne, *supra* note 2

<sup>27</sup> Herzel & Katz, *supra* note 3

<sup>28</sup> *idem*

<sup>29</sup> *idem*

<sup>30</sup> The company lawyer Dr Len Sealy writing in *The Times*, 20 January 1987 thought that in today's climate no one would defend the practice.

<sup>31</sup> Loss, *Fundamentals of Securities Regulation* (1983, *supp.*1986), cited by Hannigan *supra* note 1

<sup>32</sup> Philip LR Mitchell, *Insider Dealing and Director's Duties*, Butterworths 1989

<sup>33</sup> according to Mitchell, *supra* no 31, the best known agencies providing this service are: Jordan & Sons Ltd, Jordan House, Brunswick Place, London, N1 6EE, and Oyez Group Services Ltd, 70/74 City Road, London, EC1Y 2DQ

<sup>34</sup> CA 1985, s359(1)

<sup>35</sup> CA 1985, s325, Sch 13, Pt IV, para 25

<sup>36</sup> CA 1985, s318 (or else an 'appropriate place')

<sup>37</sup> Philip LR Mitchell, *supra* no 32

<sup>38</sup> *idem*.

<sup>39</sup> *idem*.

<sup>40</sup> *idem*.

<sup>41</sup> *idem*.

<sup>42</sup> *idem*.

<sup>43</sup> "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 *J Fin* 383, cited by Hannigan *supra* note 1.

<sup>44</sup> Paul Fenn, Alistair McGuire, Dan Prentice, "Information Imbalances and the Securities Markets", in *European Insider Dealing: Law and Practice* by Klaus Hopt and Eddy Wymeersch, Butterworths 1991.

<sup>45</sup> Janette Rutterford, *Introduction to Stock Exchange Investment*, Macmillan, 1983,



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pp. 251-283

<sup>46</sup> Paul Fenn, Alistair McGuire, Dan Prentice, *supra* note 44

<sup>47</sup> *idem*.

<sup>48</sup> distinction drawn by Fenn, McGuire and Prentice, *supra* note 44.

<sup>49</sup> see Manne, *supra*, note 2 and Gilson & Kraakman, *supra*, note 20.

<sup>50</sup> *supra* note 44.

<sup>51</sup> *Proposal for a Directive Co-ordinating Regulations on Insider Trading* (January 1989, The Law Society), cited by Fenn, *supra*, note 44.

<sup>52</sup> *idem* at page 6.

<sup>53</sup> Stabilisation is basically a price support mechanism employed to prevent the price of newly issued securities falling in the initial period to after their issue. It is a form of market manipulation which would *prima facie* give rise to an offence under section 47(2) of the FSA 1986. This section provides that any person who does any act, or who engages in any conduct, which creates a false or misleading impression as to the market in, or the price or value of, any investments is guilty of an offence. A statutory "safe harbour", however, is provided where a firm engages in stabilisation in accordance with SIB's Stabilisation Rules (section 48(7)), John R. C. White, *Regulation of Securities and Futures Dealing*, SWEET & MAXWELL, 1992

<sup>54</sup> *supra* note 44.

<sup>55</sup> Haddock and Macey, 'A Coasian Model of Insider Trading' (1986) 80 *Nev Univ L Rev* 1449, cited by Fenn, *supra* note 44.

<sup>56</sup> *idem*.

<sup>57</sup> *idem*

<sup>58</sup> *supra*, note 44.

<sup>59</sup> Hartmut Schmidt, "Insider Regulation and Economic Theory", in *European Insider Dealing: Law and Practice* by Klaus Hopt and Eddy Wymeersch, Butterworths 1991, pp.21-38.

<sup>60</sup> *idem*.

<sup>61</sup> Stützel 'Aktienrechtsreform und Konzentration' in Arnd, ed, *Die Konzentration in der Wirtschaft*, 2.Bd, Ursachen der Konzentration, Schriften des Vereins für Sozialpolitik, Neue Folge 20 II (Berlin 1960) pp946-952, cited by Schmidt, *supra* note 59

<sup>62</sup> Schmidt, *supra* note 59

<sup>63</sup> *idem*.

<sup>64</sup> Stützel, *supra* note 61, "As long as there would be one group only, as long as everybody

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*who trades shares is a 'member of the club', everyone stands an approximately equal chance to gain from doubtlessly valuable unpublished information; in this case, it may be impossible or at least quite difficult to argue in favour of inside regulation.*", Schmidt, supra note 59, p.23, ft.7.

<sup>65</sup> Schmidt, *Börsenorganisation zum Schutze der Anleger* (Tübingen 1970) pp.37-79, cited by Schmidt supra note 59

<sup>66</sup> Schmidt, supra note 59

<sup>67</sup> idem.

<sup>68</sup> idem.

<sup>69</sup> idem.

<sup>70</sup> idem.

<sup>71</sup> idem. According to the definition of the Oxford Reference Dictionary of Finance: "*market maker is a dealer in securities on the London Stock Exchange who undertakes to buy and sell securities as a principal and is therefore obliged to announce buying and selling prices for a particular security at a particular time. Before October 1986 this function was performed by a stockjobber, who was then obliged to deal with the public through a stockbroker. However, since October 1986, when the rules changed, market makers attempt to make a profit by dealing in securities as principals (selling at a higher price than at which they buy;) as well as acting as agents, working for a commission. While this dual role may create a conflict of interest for market makers it avoids the restrictive trade practice of the former system and reduces the cost of dealing in the market.*"

<sup>72</sup> idem.

<sup>73</sup> Demsetz, 'The Cost of Transacting' (1968) 82 QJ Econ 33, cited by Schmidt supra note 59

<sup>74</sup> Schmidt, supra note 59, p.26

<sup>75</sup> Treynor ('Walter Bagehot'), 'The Only Game in Town' (March-April 1971) Fin. Anal. J 12-14, 22. Treynor call outsiders 'those who trade without genuinely new information' or 'public' (p.14) and subdivides this group into liquidity traders and traders on public information. cited by H. Schmidt supra note 59, p.26

<sup>76</sup> Schmidt, supra note 59, p. 27

<sup>77</sup> 'If he is not, the wider spread will discourage outsiders to trade and because of the decrease in volume, the number of market-makers in the stock will decrease, which also tends to widen the spread. In the worst case, conceivable for stocks of small companies, insider trading will discourage market-making altogether and the lack of marketability will be mirrored in a rather high cost of capital.' H. Schmidt, supra note 59, p. 27, ft 21



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<sup>78</sup> Treynor, *supra* note 75

<sup>79</sup> Amihud and Mendelson, 'Liquidity and Asset Prices: Financial Management Implications' (1988 No 1) 17 *Fin Mgmt* 5 at 6 et seq, cited by H. Schmidt *supra* note 59, p 27

<sup>80</sup> King and Roell, 'Insider Trading' (1988) 6 *Economic Policy*, A European Forum, p 169, cited by H. Schmidt *supra* note 59, p 27

<sup>81</sup> Schmidt, *supra* note 59, p 27.

<sup>82</sup> The strong incentive of market-makers to straddle the equilibrium price closely and to change his quote in step with it explains why some markets leave the pricing entirely to market-makers (pricing by the market-maker principle) whereas others rely on the continuous periodic matching of orders (pricing by the auction principle). *supra* note 59, p 26.

<sup>83</sup> *idem*.

<sup>84</sup> *contra*: H. Schmidt, *supra* note 59, p 28, where he supports the view that since outsiders never trade with insiders neither lose individually to insiders nor do they lose as a group due to insider information.

<sup>85</sup> Georges Martin et Marc van Turenhoudt, XV 'La Concurrence dans le Domaine des Valeurs Mobilières', in *Financial Institutions in Europe under new competitive conditions*, (KLUWER) Nice October 1989.

<sup>86</sup> *supra* note 59, p 29.

<sup>87</sup> *idem*.

<sup>88</sup> *idem*.

<sup>89</sup> *idem*.

<sup>90</sup> *idem*, p 30.

<sup>91</sup> Easterbrook, 'Insider Trading as an Agency Problem' in Pratt/Zeckhauser, eds, *Principals and Agents: The Structure of Business* (Boston 1985) p 83, p4, cited by H. Schmidt *supra* note 59, p. 21

<sup>92</sup> Schmidt, *supra* note 59, p. 30

<sup>93</sup> Fortmoser, 'Gesetzliche Regelung gegen Insider-Mißbräuche?' (1982) 203 *Neue Zürcher Zeitung*, 16/17 Mai, FA 111, p10, cited by H. Schmidt *supra* note 59, p. 21

<sup>94</sup> Schmidt, *supra* note 59, pp. 30-31

<sup>95</sup> Seyhun, 'The Effectiveness of Insider Trading Sanctions', University of Chicago, Center for research in Security Prices Working Paper Series, No 248 (1988) p 6, cited by H. Schmidt, *supra* n.59, p 31

<sup>96</sup> Gupta and Misra, 'Illegal Insider Trading: Is It Rampant Before Corporate Takeovers?' (1988) *Fin Rev* 453

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- <sup>97</sup> Jaffe, 'The Effect of Regulation on Insider Trading', (1974) 5 *BellJ EconMgmtScience* 114, pp93-121, cited by H.Schmidt supra note 59, p32, *In re Cady, Roberts & Co*, 40 SEC 907 (1961), *SEC v. Texas Gulf Sulphur Co*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)
- <sup>98</sup> Easterbrook, supra note 91, p. 220 note9.
- <sup>99</sup> Gupta and Misra, supra note 96
- <sup>100</sup> Schmidt, supra note 59, p 34, where also cited: Rieschbieth, *Zur Eignung von Finanz-Kenzahlen für die Prognose von wesentlichen Ausschüttungsänderungen* (Frankfurt 1987)
- <sup>101</sup> Schmidt, supra note 59, p 34.
- <sup>102</sup> *idem*.
- <sup>103</sup> *idem*, and K. Hopt and Will, *Europäisches Insiderrecht*, (Stuttgart 1973), p 152.
- <sup>104</sup> Cf Jaffe supra note 97, Seyhun supra note 95
- <sup>105</sup> Schmidt, supra note 59, p 35
- <sup>106</sup> *idem*.
- <sup>107</sup> Carlton and Fischel, The Regulation of Insider Trading , 35 *Stan L Rev* 857 (1983), p 873.
- <sup>108</sup> Schmidt, supra note 59, p38.
- <sup>109</sup> *idem*, for the recent change in German Insider Regulation from self-regulation to criminal law see: Lorenz Frank, "Control of Insider Dealing in Germany: Proposed reform", *Journal of International Banking Law*, [1993] 8, pp. 318-322, Mennicke Petra, "Insider Regulation in Germany: the change from self-regulation to criminal law", *The Company Lawyer*, Vol 15, No 5, pp. 155-160
- <sup>110</sup> *idem*.
- <sup>111</sup> Amy E. Stutz, "A New Look at the European Economic Community Directive on Insider Trading", *Vanderbilt Journal of Transnational Law*, [vol 23:1:135 1990], p.139
- <sup>112</sup> Steven R. Salbu, " Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach", *Tulane Law Review*, vol.66, 1992, p.840.
- <sup>113</sup> Securities Act of 1933, ch.38, 48 State. 74 (codified as amended at 15 U.S.C. §§77a-77aa(1988), Securities Exchange Act of 1934, ch.404, 48 State. 881 (codified as amended at 15 U.S.C. §§78a-78ll (1988 & Supp. I 1989).
- <sup>114</sup> 78 Cong. Rec. 2264 (1934), (message from President Roosevelt)
- <sup>115</sup> *idem*.
- <sup>116</sup> Stutz, supra note 111, p.139
- <sup>117</sup> Salbu, supra note 112, p.841
- <sup>118</sup> Stutz, supra note 111, p.140



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- 119 Salbu, *supra* note 112, p.844
- 120 445 U.S. 222 (1980)
- 121 Salbu, *supra* note 112, p.841
- 122 Securities Exchange Act of 1934, section 16(b), 15 U.S.C. §78p(b).
- 123 Salbu, *supra* note 112, p.841
- 124 17 C.F.R. § 240.10b-5 (1989), Rule x-10b-5, Employment of Manipulative and Deceptive Devices, Exch. Act Release No. 3230, 7 Fed. Reg. 3804 (1942).
- 125 Stutz, *supra* note 111, p.141
- 126 Salbu, *supra* note 112, p.842
- 127 *idem*.
- 128 *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946)
- 129 *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983), The maximum amount of civil recovery (as damages) by an investor is equal to the difference between the price at which the investor sold or purchased the shares and the market price of the stock at a reasonable time after the information was announced to the public, limited by the amount gained by the wrongdoer, Stutz, *supra* note 111, p. 146, According to Donald C. Langevoort, in "Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading", *Alabama Law Review*, Vol. 39:2:399, p. 403: 'The fiction of insider trading as fraud, however, can hardly be criticised for any reason except formalism. It has led to a few doctrinal anomalies, particularly in the area of private rights of action, where the courts have developed rules of standing and measure of damages - most notably the idea of disgorgement of profits as the appropriate remedy - that fit uncomfortably with the assumption that insider trading is in fact misleading.'
- 130 see *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)
- 131 Stutz, *supra* note 111, p.141
- 132 40 SEC 907 (1961)
- 133 Reinier Kraakman, "The Legal Theory of Insider Trading Regulation in the United States", in *European Insider Dealing: Law and Practice* by Klaus Hopt and Eddy Wymeersch, Butterworths 1991, pp.39-55
- 134 *idem* p.41
- 135 *In re Cady*, *supra* note 131, at 912.
- 136 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)
- 137 Salbu, *supra* note 112, p.843
- 138 Kraakman, *supra* note 133, p.41.

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139 *idem*.

140 *idem*.

141 Salbu, *supra* note 112, pp. 840 and 843.

142 445 U.S. 1980 at 235.

143 *idem*.

144 *idem* at 230.

145 Stutz, *supra* note 111, p.142.

146 Salbu, *supra* note 112, p.844.

147 903 F.2d 75 (2d Cir. 1990), *vacated*, 947 F.2d 551 (1991)

148 Charles Vaughn Baltic III, "The Next Step in Insider Trading Regulation: International Cooperative Efforts in the Global Securities Market," *Law & Policy in International Business*, Vol.23, 1991-1992, pp.178-179.

149 463 U.S. 646 (1983)

150 *idem* at 662.

151 Vaughn Baltic III, *supra* note 148, p.179

152 *idem*

153 Kraakman, *supra* note 133

154 The Supreme Court in *Dirks* recognized the "quasi-insider" principle, stating:

*'Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired non-public corporate information, but rather that they have entered into a special confidential relationship in the conduct of business of the enterprise and are given access to information solely for corporate purposes. When such a person breaches his fiduciary relationship, he may be traded more properly as a tipper than a tippee. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed non-public information confidential, and the relationship at least must imply such a duty.'*

*supra* note 149

155 Vaughn Baltic III, *supra* note 148, p.845

156 *see* Kraakman, *supra* note 133

157 *United States v. Newman*, 464 U.S. 863 (1983)

158 *United States v. Carpenter*, 791 F.2d 1024, 1027-28 (2d Cir. 1986), *aff'd*, 484 U.S.19



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(1987)

159 *supra* note 142, at 240-45.

160 Vaughn Baltic III, *supra* note 148, p.179.

161 Donald C. Langevoort, "Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and other Curiosities in the Prevailing Law of Insider Trading", *Alabama Law Review*, [Vol.39:2:399 1988]

162 *Newman*, 664 F.2d at 16-19, and *supra* note 157

163 Stutz, *supra* note 111, p.143.

164 484 U.S. (1987), *supra* note 158

165 *idem* at 23.

166 Salbu, *supra* note 112, p.846.

167 Langevoort, *supra* note 161, p.405, for similar comments see Kraakman, *supra* note 133 at p. 46

168 Kraakman, *supra* note 133 at p.45

169 *idem*.

170 *idem* at p.47.

171 *idem*.

172 *idem*.

173 Stutz, *supra* note 111, at p.167

174 B. Rider & R. French, *The Regulation of Insider Trading*, (1979) at p.72, quoted by Stutz at *supra* note 111, p.167.

175 for an analysis see: Alcock Alistair, "Order restored to US insider-dealing law", *The Company Lawyer*, Vol 18 No 9, pp. 301-303, McCoy Kimberly, "Supreme Court affirms second theory of liability for insider trading", *The Company Lawyer*, Vol 18 No 10, pp. 335-336

176 Stutz, *supra* note 111, at p.168

177 *idem*.

178 Alain Viandier, "The Legal Theory of Insider Regulation in Europe", in *European Insider Dealing: Law and Practice* by Klaus Hopt and Eddy Wymeersch, Butterworths 1991, p.57, see Manne's thesis, cited *supra* note 2, which characterizes insider trading as an economic lubricant.

179 Viandier, *supra* note 178, at p.57

180 Lascoumes, 'Les intérêts protégés par la nouvelle loi fédérale sur les opérations d'initiés (article 1611 CBC)', SJZ 1988 p221, quoted by Viandier *supra* note 178 at p.58

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- 181 Viandier, *supra* note 178, at p.58
- 182 *idem*.
- 183 *idem*.
- 184 Klaus J. Hopt, "The European Insider Dealing Directive", *Common Market Law Review*, 27:51-82 (1990), KLUWER
- 185 *idem*.
- 186 *idem*.
- 187 M. G. Warren, Global Harmonization of Securities Laws: Achievements of the EEC, *Harvard International Law Journal*, vol.31 1990, p.194
- 188 the latter mainly analyzed by Viandier, *supra* note 177, at pp.57-62 and the therein quoted P. Catala.
- 189 P.L. Davies, "The European Community's Directive on Insider Dealing: From Company Law to Securities Markets Regulation?", *Oxford Journal of Legal Studies*, vol.11, spring 1991
- 190 *idem*, at p.92
- 191 Viandier, *supra* note 178 at p.58 where Gore-Brown quoted.
- 192 COB, Annual Report for 1976, p.9, quoted by Viandier, *supra* note 178 at p.58, see also: Carol Umhoefer and Alain Piétrancosta, "Le Délit d'Initié: Insider Trading Law in France", *Columbia Journal of International Law*, [30:89 1992]
- 193 Lascoumes, *supra* note 180, at p.225
- 194 see Davies, *supra* note 189, at p.94
- 195 *Report of the Company Law Committee*, Cmnd 1749, 1962 (Chair: The Right Honourable Lord Jenkins) quoted by Davies
- 196 Davies, *supra* note 189, at p.95
- 197 *Insider Trading*, a report by JUSTICE, 1972 (Chair: William Goodhart), para 34. The Committee did not consider the solution of providing a civil remedy to all the traders who dealt in the market at the time the insiders were operative, as the US Court of Appeals had done in *SEC v Texas Gulf Sulphur* 401 F 2d. 833 (1968), quotation and note at Davies *supra* note 189, p.96, note 18
- 198 *Chase Manhattan Equities Ltd v Goodman*, Ch D, *British Company Cases* [22-7-91]
- 199 *idem* p.339
- 200 *idem*
- 201 Carol Umhoefer and Alain Piétrancosta, "Le Délit d'initié: Insider Trading Law in France", *Columbia Journal of Transnational Law*, [30:89 1992] at p.96
- 202 *idem*.



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- 203 *idem*.
- 204 Viandier, *supra* note 178, at p.59
- 205 *supra* note 196, at para 21, quoted by Davies at *supra* note 189, p.97.
- 206 Davies, *supra* note 189, at p.97
- 207 Viandier, *supra* note 178, at p.59
- 208 *idem*, see also: Rol. Huberty, "L'introduction en droit belge du délit d'initié", *Annale de droit de Louvain*, Tome LI 2/1991
- 209 OJ EC No L 334/30, 31 (18 Nov 1989)
- 210 Viandier, *supra* note 178, at p.59
- 211 *idem*.
- 212 Farrar's *Company Law* (2d ed London 1988) p 378
- 213 Viandier, *supra* note 178, at p.59
- 214 Farrar's *Company Law*, (2nd ed London 1988) at p.365 et seq.
- 215 *idem*
- 216 Viandier, *supra* note 178, at p.60
- 217 Hopt, *supra* note 184, at p.56
- 218 see OJ C153/80 of June 1987
- 219 Michael Ashe, "The Directive on Insider Dealing", *The Company Lawyer*, Vol 13 No 1 p.16, see also Brenda Hannigan, "Regulating Insider Dealing-The EEC Dimension", *Journal of International Banking Law*, [1989] 1, at p.11
- 220 Davies, *supra* note 189, at p.103
- 221 Carol Umhoefer and Alain Piétrancosta, *supra* note 201, at p.117
- 222 Mireille Delmas-Marty, *Le «délit d'initiés» va-t-il changer la bourse?*, 1977 D.S. CHRONIQUE, at p.94, quoted by Umhoefer and Piétrancosta, *supra* note 201 at p.117.
- 223 Freyria, *Les Aspects Répressifs de la Réglementation Boursière Actuelle*, REV. DR. BANCAIRE & BOURSE, July/August 1988 at 113, cited by Umhoefer and Piétrancosta, *supra* note 201, at p.121
- 224 translation by Umhoefer and Piétrancosta, *supra* note 201 at p.121 footnote 140
- 225 Viandier, *supra* note 178 at p.61
- 226 *idem*, see also note 204.
- 227 Davies, *supra* note 189 at p.103
- 228 *idem*
- 229 Viandier, *supra* note 178, at p.61
- 230 Convention on Insider Trading, Council of Europe, No. 130. The Convention was opened

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for signature on April 20, 1989.

231 T. Tridimas, "Convention on Insider Trading", *European Law Review*, October 1991, at p.438

232 Viandier, *supra* note 178, at p.61

233 *idem*.

234 *idem*.

235 *supra* note 158

236 COB, Annual Report for 1976, p 6, quoted by Viandier, *supra* note 178 at p.58

237 Viandier, *supra* note 178, at p.62

238 *idem*

239 *idem*

240 Department of Trade and Industry, *The Law on Insider Dealing: A Consultative Document*, 1989, para 2.23-2.24

241 Davies, *supra* note 189, at p.104

242 *idem*

243 Viandier, *supra* note 178, at p.62

244 Davies, *supra* note 189, at p.105

245 on the French experience see Viandier, *supra* note 178, at p.62



## C. The European Insider Dealing Directive<sup>1</sup>

### Analysis

The application of the Directive is determined by the presence of certain elements which constitute "insider dealing". Specific conditions concerning persons who have special duties, the nature of the information these persons possess and the securities to which this information relates are of critical importance.<sup>2</sup>

#### 1. Insiders

The possession of "inside information" is a *conditio sine qua non* for the application of the insider dealing prohibition but "if everybody who got hold of a piece of inside information had to be considered as an insider", as Professor Hopt remarks, "this would hamper even disclosure to the public."<sup>3</sup> The concept of *insider* should be, therefore, modified beyond the mere possession of inside information. Every insider regulation must fulfil this requirement.

Insiders are usually classified into two categories: firstly, those in direct contact with inside information by status or profession and, secondly, those who get to know the inside information from the persons of the first category. The first category are called *primary* and the second *secondary* insiders. The distinction is not made by the text of the Directive but has been used in the preparatory work and is used by many commentators.<sup>4</sup> The terms *company insiders*, for the first category, and *tippees* for the second have also been used. In the opinion of Hopt the term *company insiders* is too narrow for the scope of the Directive and the term *professional insiders* could be an appropriate alternative given that

the Directive extends the first category of insiders beyond the company insiders including the shareholders of the company and, generally, all those who get access to inside information by their status or profession.<sup>5</sup> The practical importance of the distinction between *primary* and *secondary* insiders is that each group falls into the scope of application of certain different rules.<sup>6</sup> At this point it should be noted that primary insiders can be natural persons or legal entities as specified in Article 2(2) of the Directive. In that case the Directive applies to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned.<sup>7</sup>

#### a) primary insiders

Primary insiders are defined by the Directive in Article 2(1) as follows:

*-[persons possessing inside information] by virtue of their membership of the administrative, management or supervisory bodies of the issuer,*

*-[persons possessing inside information] by virtue of their holding in the capital of the issuer,*

*-[persons possessing inside information] because they have access to such information by virtue of the exercise of their employment, profession or duties*

The two first sub-categories were introduced in the final draft following a German demand, apparently reiterating the issuer-related insider concept which underlies the German Insider Trading Guidelines. This view aims at penalising the misuse of information which has been entrusted to someone, or which he knows because of his position in the company. As the French *Commission des opérations de bourse* succinctly put it, this information constitutes "*an element of common patrimony*."<sup>8</sup> If the wording of the definition loosened this connection to the issuer, the prohibition would be unlimited and eventually lead to the



criminalization of securities trading.<sup>9</sup>

According to the Directive, among primary insiders are those who possess inside information by virtue of their *membership of the administrative, management or supervisory bodies of the issuer*, of the securities concerned. This enumeration is an effort to include all members of different boards existing in the company law of various Member States. In Germany there is the *dual board* system (management board and supervisory board). In France the *unitary board* with the president at the top (P.D.G.) is prevailing but the option for the dual system is open. The scope of the Directive is broad enough as to cover insiders from all these systems.<sup>10</sup> In addition managers of firms other than joint-stock companies which may issue, e.g. debt securities are caught by the Directive.

French commentators analysing the community legislation in the light of the relative "*ordonnance*"<sup>11</sup> support the view that the Directive imposes on company directors a *presumption of knowledge* of the privileged information.<sup>12</sup> This presumption seems to have been influenced by the idea that these particular persons would be more tempted to make use of the information they are banned from using. A reasonable objection could be that the directors are not always well informed of the situation of their companies, and the relative presumption could be, in certain cases, unjustified.<sup>13</sup> The analysis, nevertheless, of the French "*Jurisprudence*" reveals that one fourth of the known insider dealing cases since 1975 involve persons from the administrative board of companies (*mandataires*).<sup>14</sup>

A question directly related to the presumption that the Directive imposes on directors is whether this presumption is a *rebuttable* or an *irrebuttable* one.<sup>15</sup> Although the Directive makes the distinction between the persons who have qualities of "*membership of the administrative,*

*management or supervisory bodies of the issuer*" and those have access to insider information "by virtue of the exercise of [their] employment, profession or duties",<sup>16</sup> it demands, in both cases, that these persons take advantage of "that information with full knowledge of the facts"<sup>17</sup> for the act to be reprehensible.<sup>18</sup> The presumption of knowledge can, therefore, be rebutted by all suspect insiders if they prove that they have not taken advantage of the information they possessed or that when doing so they did not have full knowledge of the facts.

The Directive goes further and includes as a second group of primary insiders persons who possess inside information by virtue of their *holding in the capital of the issuer*. The prohibition applies to all shareholders irrespective to the amount of their participation on the condition that they possess information *by virtue* of their shareholding, which implicitly sets a minimum which may vary according to the circumstances. Hopt suggests that if Member States introduce a registration system for company insiders "they are free and well advised to limit the registration bureaucracy to major shareholders for example from 10 per cent up."<sup>19</sup> It should be noted, however, that under the UK Companies Act 1985 all shareholders with an interest of at least 3 per cent of all the issued shares of the company, or all the issued shares of the same class, which carry the right to vote in all circumstances, have a duty to notify the company of their interests.<sup>20</sup>

In the case of shareholders the argument *for* the rebuttable presumption set by the Directive is particularly strong: It would be inconceivable to impose on everyone, who has acquired shares of a company, a presumption of knowledge of the inside information without permitting him to bring evidence of his ignorance. This particularly convincing argument considering shareholders reinforces the



interpretation according to which directors are also subject to a simple presumption<sup>21</sup>

Many insider regulations cover expressly *members of the same group of companies*.<sup>22</sup> Under the Directive members of the same group of companies will sometimes be covered already as primary insiders by virtue of their shareholdings. This is the case in parent companies and also for the subsidiaries in reciprocal holdings. But if the situation is more complicated, if, for example there is a line of *parent - subsidiary - subsidiary* or a *horizontal* line of holdings, difficulties may arise. The wording of Art 2(1) of the Directive expressly demands a *direct* holding. In national legal systems which have adopted criminal sanctions against insiders there will not always be the possibility of *analogies* against members of the same group of companies since national legal systems do not permit analogies to the detriment of the accused. In all probability, these members of the same group, who will not be caught by the prohibition regarding primary insiders, can be subject to insider dealing prohibition as secondary insiders.<sup>23</sup>

The first two categories are delimited by the terms "*of the issuer*". The first question which the use of these terms raises, is whether persons, who at the time of trading do not belong to the issuer anymore, can have insider status. It can be easily inferred from the fact that the insider must know the information *by virtue* of his connection with the issuer, that this question should be answered in the affirmative. The same solution has been followed by Great Britain and Germany. It is also uncertain whether persons who have never belonged to *the issuer* but are members of another (possibly affiliated) company can be insiders. The problem in this particular case is aggravated by the word "*the*" issuer, which restricts the prohibition to the insiders who are connected with the company

whose securities are actually traded. It should be noted that Members are free to "extend the scope of the prohibition laid down in Article 2."

The most controversial point of the Directive is the large definition of the third, and broadest in scope, category of primary insiders. With a rather general clause all persons who have *access to inside information by virtue of the exercise of their employment, profession or duties* can be insiders. This group has been correctly characterised as heterogeneous. It embraces people having a contractual relationship with the issuer or company-connected persons such as employees or auditors of the company as well as people with no connection at all with the issuer such as e.g. members of the central bank, the press, or stock exchanges. The only condition imposed on insiders of this category is that they have access to inside information by virtue of their *status*.<sup>24</sup> French commentators have proposed the distinction between "*internal*" insiders (*initiés internes*) and "*external*" insiders (*initiés externes*) according to the criterion of their employment by the issuing company.<sup>25</sup>

The enumeration covers in the first place "all persons having entered into a contractual or quasi-contractual relationship with the issuer", i.e. internal insiders. As Bergmans observes, since the Directive does not require the breach of duty or the misappropriation of information, consequently, even lawfully acquired inside information may not be used under the prohibition.<sup>26</sup> The emphasis has been rightly moved from the way the information was acquired to the way it was used.

Commentators seem to agree on the point that the access to information must be a direct *corollary* of the exercise of their employment,<sup>27</sup> because the Directive uses again the terms "*by virtue*" instead of "*on the occasion*."

The Directive does not contain a qualification as to the group of



*employees* of the issuers who are covered. It should be noted that most insider regulations are rather restrictive "either by enumeration, seniority or sometimes even salary."<sup>28</sup> Professor Hopt refers to the German voluntary Insider Trading Guidelines which cover only the employees who by virtue of their job *habitually* get to know inside information.<sup>29</sup> The Directive sets the precondition that the employees have access to inside information by virtue of their employment. This must simply mean that the access to inside information is a *consequence*<sup>30</sup> of the position but this particular position should not necessarily give *organisational* or *regular* access to inside information. Even incidental access could be adequate. Again Hopt suggests that the legislators of the Member States should consider a registration system limited to "employees who *habitually* get inside information."<sup>31</sup> This solution would unnecessarily limit the scope of the regulation for the sake of certainty.

External insiders can be defined as the group of persons external to the issuing company who have access to inside information because of the exercise of their profession or duties. The French jurisprudence has notably considered as external insiders an architect, a journalist, a banker and a "head hunter."

*Auditors* are among the persons who could fall into the scope of application of the Directive because the auditing task makes them primary (external) insiders by virtue of their profession, since at least in the civilian legal systems the status of a company organ and the independence necessary for fulfilling the auditing task are incompatible.<sup>32</sup> All persons who have business relations with the issuer can be insiders if they get inside information by virtue of the exercise of their profession. If they act 'without remuneration or in their private capacity', they can be primary insiders by virtue of their duties.<sup>33</sup>

Most of the aforementioned persons have a contractual or quasi-contractual relationship with the issuer which in a considerable number of cases establishes a special fiduciary duty towards the issuer. Prof. Hopt observes that some professionals may have a contractual relationship with the issuer which is not of a fiduciary character (e.g. in vendor-buyer relations) or some persons may have no contractual relationship with the issuer at all and, nevertheless, be able to be primary insiders because, as will be seen, under the Directive the concept of inside information includes also inside information which influences only the market as such.<sup>34</sup> Consequently, 'members of the central bank, the press, the parliament, the ministry of economics and of other institutions, committees and bodies who possess inside information because of their profession or their duties'<sup>35</sup> can be primary insiders if they make use of non-publicly available price-sensitive information.

#### **b) secondary insiders**

The Directive prohibits all primary insiders in possession of inside information from (Art. 3):

*"(a) disclosing that inside information to any third party unless such disclosure is made in the normal course of the exercise of his employment, profession or duties;*

*(b) recommending or procuring a third party, on the basis of that inside information, to acquire or dispose of transferable securities admitted to trading on its securities markets as referred to in Article 1 (2) in fine."*

It is not clear whether the Directive requires "knowing" behaviour by the "tipper"<sup>36</sup>, but it seems certain that Art. 3 refers to Art. 1 as a whole imposing, thus, the same standard of liability on both the "tipper" and the "trader."



The *disclosure* prohibition is delimited by an exception if such disclosure is made in the normal course of the primary insider's employment, profession or duties. This exception does not apply in the cases of *recommendation* and *procuration* where tipping is possible without disclosing the inside information to the third party.

The necessity for leaving intact the "normal information flow in business and professional contacts"<sup>37</sup>, dictates its exclusion from the prohibition. The Directive cannot and, perhaps, should not specify what the normal course of the exercise of the employment, profession or duties of the primary insider (bank, broker, solicitor, auditor, fiduciary etc.) is. The important thing is that the Directive should let all relevant professionals do their job. It is for the law governing the rights and duties of these professionals and their clients to decide on the confidential nature of information. Gaillard and Pingel remark that, as has already happened in the French legislation, it will not be always easy to know what is the "confidential" information which could be communicated to a third person in the normal exercise of a certain profession and, therefore, questions of interpretation may arise.<sup>38</sup>

The distinction between disclosure and recommendation will be very difficult to apply in the case of professional securities advisers.<sup>39</sup> Even if a tip from the latter, which contains unpublished information, does not constitute disclosure, it will most probably amount to recommendation.

The importance of distinguishing primary and secondary insiders cannot be overemphasised especially in the previous case. Secondary insiders are not prohibited from tipping<sup>40</sup>, unless the legislation of the particular Member State adopts more stringent provisions and imposes the prohibitions laid down in Article 3 on the persons referred to in Article 4<sup>41</sup>. As Bergmans remarks 'it would be up to the client-tippee then

to appreciate whether he would be liable as a secondary insider.<sup>42</sup> In countries with a *universal* or *all-purpose* banking system (i.e. the banking that involves not only services related to loans and savings but also those involved in making investments in companies), as Professor Hopt states, the content and scope of these rights and duties may be rather controversial,<sup>43</sup> in view of the conflicts of interests inherent to the system. The same commentator takes the argument one step further claiming that under certain circumstances the banks may have a duty to disclose inside information to their clients in order to keep them from being damaged wrongfully.<sup>44</sup>

The Directive may not be applicable in the case of *front-running* where an investment adviser is about to issue public investment advice based on publicly available data and trades on the securities concerned ahead of his clients and the public. This practice is clearly undesirable irrespective of its legal evaluation. It has been proposed that even if the content of the advice is public knowledge, according to the Preamble of the Directive, 'the fact that the investment adviser will issue the advice and thereby exert a certain influence on the appreciation of a security is inside information.'<sup>45</sup> The sanctioning of this behaviour will be further examined in relation to the definition of public information.

Article 4 of the Directive treats *secondary insiders* or *tippees* in a less strict manner than the primary ones. It states that:

*"Each Member State shall also impose the prohibition provided for in Article 2 on any person other than those referred to in that Article who with full knowledge of the facts possesses inside information, the direct or indirect source of which could not be other than a person referred to in Article 2."*

It has already been mentioned that for secondary insiders the tipping prohibition of Article 3, as specified by Article 6 sentence 2, is optional.



The Directive does not use either the term secondary insider or tippee but sets as its only prerequisite that the person with full knowledge of the facts possess information the direct or indirect source of which could not be other than a primary insider. It is evident from the wording of Article 4 that a tip between the primary and the secondary insider is not essential. The term tippee is not, therefore, in this particular case, fully correct.<sup>46</sup> The whole chain between the primary and the secondary insider is caught by the provision. What must be established is that the (not yet public) information emanates from a primary insider. No specific person needs to be incriminated, neither does the way information was leaked have to be detected. The secondary insider must, nevertheless, be conscious of the connection of the particular information with primary insiders, since full knowledge of the facts is necessary.

On the point which was last raised Bergmans remarks that it is not 'devoid of uncertainties', especially as it is contingent upon the judgement of the person in possession of inside information to 'appreciate whether its direct or indirect source can be other than a primary insider.'<sup>47</sup> The latter will be a rather rare occurrence considering the breadth of the definition of primary insiders.<sup>48</sup> Thus, the Directive imposes on people, who obtained or may obtain information, a duty to evaluate it. This duty does not appear to cease before the person in possession of the relevant information trades on it or before that information becomes public. If, before trading, he 'becomes aware that he holds inside information'<sup>49</sup>, he should abstain or be subject to the prohibition.

The only importance of the length of the chain between the primary and the secondary insider seems to be the probable loss of the inside character of the information which is due to the fact that, along the chain, more people are likely to know it without being aware of the relevant

facts.<sup>50</sup> Bergmans observes that securities professionals such as analysts, advisors, could be put in a delicate position as "secondary or tertiary tippees" on the line, since they could risk rendering their clients secondary insiders.<sup>51</sup> As already mentioned, secondary insiders are not prohibited from disclosing in the course of profession or procuring<sup>52</sup>, and this could to a certain extent secure the unimpeded conduct of their business.

For the insider dealing prohibition for secondary insiders it does not matter whether the primary insider has made a legal or an illegal disclosure of the inside information.<sup>53</sup> The distinction of Article 3 is not made in the case of Article 4. The only decisive element is that the source of the relevant information could only be traced to a primary insider. As Professor Hopt remarks, a person who receives inside information without breaking the law has not automatically the right to use it on the securities markets. According to the Directive, even if a person has overheard, by chance, the conversation of a primary insider with others, as in the notorious hypothetical case of the taxi driver who listens to a conversation between company directors on the back seats, he can be a secondary insider.<sup>54</sup> On the other hand it has been observed that a person who steals information from the books in the company without the involvement of a primary insider does not seem to fall within the scope of Article 4. This distinction may lead to controversial solutions. Treating both cases alike would be advisable, therefore, to the Commission and Member States legislators.

## **2. Inside Information**

The key concept of each insider regulation is the definition of inside information. This definition influences the determination of the



prohibitions and the obligations set out in an insider regulation. According to Article 1(1) of the Directive:

*" 'inside information' shall mean information which [1] has not been made public [2] of a precise nature [3] relating to one or several issuers of transferable securities, which, [4] if it were made public would be likely to have a significant effect on the price of the transferable security or securities in question."*

The concept of inside information is, therefore, determined by the cumulative combination of 'different parameters delineating its scope'<sup>55</sup>:

**a) status**

The information must not have been made public. This formula is less ambiguous than the one of the Company Securities (Insider Dealing) Act 1985 which required that the information must 'not be generally known to these persons accustomed or likely to deal in the company's securities'.<sup>56</sup> It is irrelevant whether the information is confidential, not to be published or to be disclosed later on. Yet the meaning of having been made public can be interpreted in two different ways: either that the information is generally available or accessible to the public or that the information must actually be known by the investing public.<sup>57</sup> As Professor Hopt remarks the difference is subtle but important.<sup>58</sup> If the mere fact of giving the information to the public sufficed, the board members would be allowed to give telephone orders to their broker as soon as the news have been disclosed in the general assembly. Especially under a civil law concept the fact that the information was given away by a telegram or a letter to the stock exchange<sup>59</sup> would be considered sufficient.

It can be reasonably assumed that the intention of the Directive is not to allow insiders to beat the news by trading immediately, ahead of the general public.<sup>60</sup> The first interpretation, therefore, would result in giving the insiders a short period of time in which they can use their

information, which is no longer inside information. Insiders could also avoid liability if the recently made public information is still restricted to a limited circle of persons.

The second interpretation is preferable, as pointed out by Hopt<sup>61</sup>, because it does not allow the insider to beat the news. The German version of the Directive undoubtedly supports the second interpretation since it uses the words "*nicht öffentlich bekannt*" i.e. not publicly known. But there is still considerable uncertainty as to the moment from which the information can be considered public. Some writers adopt a more cautious approach and claim that the information must not only be announced but must also be assimilated<sup>62</sup> or that the insiders must respect a certain waiting period in order to allow "not only the information to be disseminated by mass media or specialised publications, but also the public to react and prices to adapt to the news."<sup>63</sup> Apparently, the latter view has been followed by some insider regulations which require the insider to wait until the information has been absorbed and evaluated by the stock exchange and the public, whereas some others ask for a more practical 24 hours waiting period after disclosure.<sup>64</sup>

The most convincing interpretation of Article 1(1) seems to be the one advanced by Prof. Hopt: "the mere fact of giving the information away to the public is not sufficient, but it is necessary that the information is available to the investing public ticker or by having been reported by public media such as television, radio or the economic press."<sup>65</sup> With the massive development in the last decade of information technology in the securities industry and the advent of screen dealing as the norm in the major markets, it may be that when the announcement '*hits the screen*' it has effectively been made public and the insider may be free to deal.<sup>66</sup>



## **b) nature**

The information must be of a *precise nature*. This is an attempt to distinguish rumour or idle speculation from hard fact. Rumours and speculations are a very common occurrence in the market and they play a useful economic role. A market participant should not be barred from trading based on a rumour or a personal deduction from rumours or facts that do not constitute inside information.<sup>67</sup>

In addition, the information must be *likely to have a significant effect on the price of the securities if it were made public*. This qualitative test exists in all insider regulations. Inside information must have a price-sensitive impact.

The probable effect of information to the price of securities must be judged at the time of the insider dealing transaction and it will be a rather difficult task to make such a prognosis. The actual influence of the publication of the information on the stock-exchange quotations has been correctly criticized as irrelevant since it can depend on many reasons and coincidences.<sup>68</sup> The actual, nevertheless, price change observed after publication will be a useful indicator which should be taken into account in evaluating the significance of the impact.

The task of assessing the price-sensitive effect of inside information is subject to the further qualification that this effect must be significant. Only inside information with probable significant effects on the price is considered. This 'significance' test has been criticised as vague.<sup>69</sup> Member States will find difficulties in defining what is a significant price increase in any detail. The significance of the price change may vary from share to share and it will be, therefore, impossible to set a universal standard.

## **c) object of information**

The information must relate to *one or several issuers of transferable*

*securities or to one or several transferable securities.* Firstly, on information *relating to the issuer* the Commission underlined that it can be either internal or external information.<sup>70</sup> It cited as an example of internal information increases or cuts in dividends and as an example of external information a take-over bid concerning the company.<sup>71</sup>

Secondly, regarding information *relating to the securities* (as opposed to the information concerning the company itself) the Commission stresses that it can comprise information on the situation or the prospects of the securities in question as well as information that can influence only the market as such.<sup>72</sup>

The decision, for example, not to grant subscription rights, planning measures for watering down the value of a stock or even a decision of the board of the stock exchange concerning listing can be information which is relating to one or several securities.<sup>73</sup> Information which is likely to influence the market as such could be, for example, the decision of the central bank to change the discount or bank rate.<sup>74</sup>

The definition of inside information in Article 1(1) has been characterised as 'extremely far-reaching'<sup>75</sup> because it can also sanction trading on the basis of political news or even economic news from foreign countries. The distinction of market-related news with a probable impact on economic life from clearly political news with a similar impact is almost impossible. Limits to the broad scope of the definition should be looked for in the concept of insider and the prohibitions or duties imposed on them by the Directive.<sup>76</sup> On the other hand the breadth of the definition of privileged information offers the possibility to national legislations to adapt to the more recent developments in the stock-markets.<sup>77</sup>



d) source

If the information has actually been made public it is of no importance who published it or whether its publication was a result of a breach of duty or a violation of law. Anyone can trade on it and only the persons responsible for its illegal publication will have to face sanctions.

The Preamble of the Directive expressly states that *estimates developed from publicly available data* cannot be regarded as inside information and, consequently any transaction based thereupon does not constitute insider dealing. This clarifies the situation regarding portfolio analysts or investment advisers. Their business is to use all information available about the securities they are dealing with. As long as they do not make use of information which has not been made public they will not be liable and they will not take the risk of rendering secondary insiders the clients they are advising.

In the Preamble there is also provision for the case of take-over bids. The mere acquisition or disposal of transferable securities, according to the statements of the Council, does not constitute in itself the use of inside information, since the acquisition or disposal of transferable securities necessarily involves a prior decision to acquire or to dispose taken by the person who undertakes one or other of these operations. If the elements of the Directive were taken literally the prospective bidders would be barred from buying shares ahead of the public announcement of the bid.<sup>78</sup> This would create problems in connection with take-over rules that, normally, allow the bidder to buy up shares silently up to the percentage as of which there is mandatory disclosure.<sup>79</sup> Considering the probability of insider dealing arising in take-over contexts, the efficiency of the Directive in harmonising take-over laws of Member States is of undeniable importance.

### 3. Transferable securities

In contrast to Article 5 of the 1988 draft Directive, the definition of transferable securities in Article 1(2) of the Directive embraces practically all forms of securities traded in the markets. These are:

*"(a) shares and debt securities, as well as securities equivalent to shares and debt securities;*

*(b) contracts or rights to subscribe for, acquire or dispose of securities referred to in (a);*

*(c) futures contracts, options and financial futures in respect of securities referred to in (a);*

*(d) index contracts in respect of securities referred to in (a),*

*when admitted to trading on a market which is regulated and supervised by authorities recognised by public bodies, operates regularly and is accessible directly or indirectly to the public."*<sup>80</sup>

Although exhaustive lists always arouse the suspicion of incompleteness<sup>81</sup>, the list contained in the Directive provides better protection for investors than the draft directives which mentioned only stock, debt and transferable options with respect to them.<sup>82</sup> The extension of the scope of the definition was proposed by the Council of the European Communities and seems reasonable since insider dealing can also occur in relation to such financial instruments, even though, as Prof. Hopt has pointed out, it may be more indirect or 'more difficult to trace because the trading may be done in separate markets.'<sup>83</sup>

The transferable securities in question are covered when '*admitted to trading on a market which is regulated and supervised by authorities recognised by public bodies, operates regularly and is accessible directly or indirectly to the public.*' This broad definition is an attempt to include different types of markets existing in the European countries avoiding,



thus, the 'pitfalls' of requiring either official listing or 'stock exchange'.<sup>84</sup> Markets such as the "*second marché*" in France, the "*unlisted securities market*" in Great Britain, the "*mercato ristretto*" in Italy, the "*paralili agora*" in Greece, the "*Freiverkehr*" and the "*geregelter Markt*" in Germany are, therefore, covered by the definition.<sup>85</sup> This is particularly important for new forms of financial markets which lack some of the traditional elements of the stock exchange concept, as, for example, in computerised securities markets where market participants are not physically present at a single place,<sup>86</sup> and will probably achieve to a great extent the aim of uniformity in the insider regulations of Member States.

It should be noted that Article 2(3) of the Directive gives Member States the opportunity to exclude over-the-counter sales, i.e. sales without the involvement of a professional intermediary, from the prohibition of insider dealing. The argument has been advanced that insider dealing on smaller markets in the shares of small or medium-sized companies may be of much higher intensity and lead to a more perceptible distortion of the market than insider dealing in the shares of a well-known company on a recognised stock exchange.<sup>87</sup> Member States would be, therefore, well advised not to make use of the authorisation given to them by Article 2(3).

#### 4. Prohibitions

According to Article 2(1) of the Directive a primary or secondary insider possessing inside information may not take

*"advantage of that information with full knowledge of the facts by acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which that information relates."*

The *scienter* requirement is interesting. The insider must act *with full knowledge of the facts*, in other words he must know what he does. Accordingly, it must be shown that the insider acted wilfully.<sup>88</sup> Mere negligence, even gross negligence, as Hopt points out, is not enough.<sup>89</sup> This restriction was not included in the draft Directives<sup>90</sup>, but was added in the last in the final version as a clarification. It may be important as a matter of principle but has, nevertheless, little practical consequence. It is clear that making use of a privileged information in the stock market could not result from an inattention. In most cases the insider will be making use of the information with full knowledge of the facts.<sup>91</sup> The penal prosecution of a person who violates the prohibition could be successful in the jurisdictions of practically all Member States if the violation was wilful.<sup>92</sup> Member State legislators can, of course, adopt a stricter solution, following the example of France, and impose sanctions on the insider even if 'it cannot be proved that he acted *scienter*.'<sup>93</sup> It is not necessary for the insider to intend to achieve gain or the avoidance of a loss of himself or a third party. In addition, it is not required that the transaction actually yielded a profit<sup>94</sup> since this may depend on '*fortuitous circumstances*'.<sup>95</sup> The existence of gain will probably be taken into account for the determination of the penalty.<sup>96</sup>

Whereas inside information can only be possessed by natural persons, transactions can be effected for the account of legal entities. As has already been remarked in the beginning of this chapter<sup>97</sup>, Article 2(2) of the Directive states that, where the insider is a company or other type of legal person, the prohibition shall apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned. This rule should be read in the light of the laws of most Member States under which it is inconceivable to have legal persons



prosecuted penally. Wherever this is possible, as in the case of Germany where legal persons can commit quasi-criminal irregularities (*Ordnungswidrigkeiten*),<sup>98</sup> Member States are able to apply the same rules for insider dealing to legal persons, provided the natural persons themselves are also subject to the prohibition. The Council Protocol, the Council and the Commission declare that, in conformity with Article 6, every Member State may apply the prohibition of Article 2(1) and the resulting penalties also to legal persons directly.<sup>99</sup>

This prohibition applies to any acquisition or disposal of transferable securities on an official market as defined in Article 1(1&2) and to any such act effected through a professional intermediary [Art 2(3)], even outside such an official market. As has already been mentioned<sup>100</sup>, Member States may exempt transactions effected without the involvement of a professional intermediary outside an official market [Art 2(3)]. In that case the probable sanctions should be based on traditional civil or penal law concepts.<sup>101</sup> The two conditions of the exemption clause i.e. lack of involvement of a professional intermediary and execution of a transaction outside an official market, have to be met cumulatively.<sup>102</sup> The word "involvement" is so broad that even help and advice from intermediaries is covered. The intermediary need not act as a go-between. In countries<sup>103</sup> following the universal or all-purpose banking system banks (apart from official or unofficial stock brokers) act as professional intermediaries.<sup>104</sup> According to Professor Hopt the two conditions set in the exemption clause will also affect *block trading* ( *Pakethandel* ) which in Germany belongs to the domain of banks. The latter help private buyers and sellers as well as enterprises to find out and bring about such deals. As a result of the terms of the exemption, block trading could not be exempted 'unless it is done by the buyer and the seller alone'.<sup>105</sup>

The Directive does not prohibit *failure to transact* by reason of inside information. Despite the fact that gains can also be realised by avoiding the 'wrong' transaction, the same solution has been adopted by most insider regulations. As a matter of practice it can be enormously troublesome to prove the connection between the insider information and the omission.<sup>106</sup>

The decision of the insider to trade must be connected causally with the possession of information. At least the wording of the Directive which requires the insider to be '*taking advantage of that information with full knowledge of the facts*' leads to that conclusion. The latter is confirmed by the exclusion in the Preamble of three cases of professionals who often possess inside information and who normally do not trade on the basis of an independent decision. According to the Preamble:

*"the mere fact that market-makers, bodies authorised to act as contrepartie, or stockbrokers with inside information confine themselves, in the first two cases, to pursuing their normal business of buying or selling securities or, in the last, to carrying out an order should not in itself be deemed to constitute use of such inside information; [...] likewise the fact of carrying out transactions with the aim of stabilising the price of new issues of secondary offers of transferable securities should not in itself be deemed to constitute use of inside information".*

As to *market-makers* or bodies authorised to act as "*contrepartie*", the fact, according to Hopt, that they "make the market" is price sensitive by definition.<sup>107</sup> It is, nevertheless, necessary for the fulfilment of their duties that their intervention be not deemed to violate the insider dealing prohibition. Stockbrokers who execute an order should not be hindered in their professional activities because of the fact that they possess inside information. Similarly, as Gaillard and Pingel remark, it would be inopportune to impede the normal activities of financial intermediaries



by imposing on them a duty to verify the circumstances that lead their clients to a transaction every time there can be doubts as to their motives.<sup>108</sup>

A different problem arises when the intermediary makes use for himself or for another client of the information he acquired in the exercise of his functions, especially, when an order of significant volume constitutes in itself privileged information. This case falls outside the scope of the Preamble of the Directive and should be dealt with in the legislations of Member States. The latter do not seem to have found an answer to that question yet.<sup>109</sup>

The practice of *stabilising* the price of new issues or secondary offers of transferable securities is also exempted from the insider dealing prohibition. It is left to the national legislator to decide under what circumstances stabilisation is allowed. Considering the wide disparity in the solutions that have been adopted so far<sup>110</sup>, the regulation of the stabilisation practices in the EC will almost certainly lack homogeneity.

Finally, the Directive restricts its scope in Article 2(4) stipulating that it shall not apply to:

*"transactions carried out in pursuit of monetary, exchange-rate or public debt-management policies by a sovereign State, by its central bank or any other body designated to that effect by the State, or any other person acting on their behalf. Member States may extend this exemption to their federated States or similar local authorities in respect of the management of their public debt."*

This is part of the general policy in EC legislation and aims at safeguarding the economic sovereignty of Member States.<sup>111</sup> It can not be overemphasised that this exemption from the general rule should be construed narrowly.<sup>112</sup>

The prohibition of tipping has already been examined in relation to

secondary insiders.<sup>113</sup>

## 5. Sanctions

The Directive does not specify what type of penalties the Member States should introduce for the violation of insider dealing regulations. According to Article 13:

*"Each Member State shall determine the penalties to be applied for infringement of the measures taken pursuant to this Directive. The penalties shall be sufficient to promote compliance with those measures."*

The Commission, lacking the power to enact criminal sanctions itself because of the EC-Treaty, has left the penalties (civil or criminal) to the discretion of Member States. The Committee for Law and Civil Rights of the European Parliament, judging the Commission proposal to be insufficient, required that sanctions for insider dealing should also be harmonised.<sup>114</sup> The Commission was unwilling to follow this solution for fear of political disagreements and simply added a second sentence according to which the sanctions must be so deterrent that observation of the provision is warranted.<sup>115</sup> The Council reached the final wording in the common position of 20 July 1989. In an attempt to justify the terms finally adopted, the Council underlined that not even the strictest sanctions could guarantee the observation of a rule one hundred per cent.<sup>116</sup> The Directive provides, in general terms, that the sanctions (penalties in the English text, *sanctions* in the French and *Sanktionen* in the German) must be sufficient 'to promote compliance with those measures'.

Although the Directive is an improvement over the first proposal, harmonisation of the penalties and the civil remedies would be a more



efficient approach. The primary goal of fostering confidence in the EC securities market, as set out in the Preamble, will not otherwise be met.<sup>117</sup>

The Directive by using the term '*penalties*' does not confine the possible sanctions to those of criminal law. Civil sanctions are not excluded and it is not clear whether Member States are obliged to use criminal penalties. This is an important issue in countries which opposed the imposition of criminal sanctions.<sup>118</sup> Especially in Germany there have been lengthy discussions about the adequacy of such sanctions for insider dealing. There were the usual<sup>119</sup> arguments in favour of voluntary restraints and a limited applicability of the insider dealing prohibition. It has also been argued that weak civil penalties may have no preventive effect and, therefore, stricter civil sanctions or specific criminal provisions should be created. The existence of a criminal sanction is not determining as the international experience of very few convictions shows.<sup>120</sup> This, of course, is closely connected with the difficulties in detecting the offence and with problems related to the efficiency of enforcement.

Professor Hopt has made in relation to insider dealing sanctions a well-aimed observation:

*"The international experience shows that it is unwise to rely exclusively on criminal sanctions. Sometimes civil law, administrative law or disciplinary and self-regulatory sanctions are more effective. It is hoped that Member States will not settle for a quick and easy transformation by just having a penal provision which may or not be effective, but that thought will be given to embedding such a penal provision in its company and stock exchange setting."*<sup>121</sup>

In other words Hopt supports that the existing codes of conduct, stock-exchange and other disciplinary or self-regulatory sanctions should not be done away with. The harmonisation of civil law liability rules poses undeniably more problems than the simple creation of a new criminal

offence. On the other hand, particular investors or companies should not be left without remedies in most cases. An important and necessary measure would be the disgorgement of profits. The intensity of the penalties should be strong enough to have a deterrent effect and should vary according to the particular behaviour or the particular aim to be achieved.<sup>122</sup>

In recent years, it has become apparent that British regulators tend to be less effective at tackling the problem of enforcement than some of their foreign counterparts. In 1993, for example, France's regulatory authority, the *Commission des Opérations de Bourse* (COB), fined ten people for insider-trading; America's *Securities and Exchange Commission* (SEC) fined 34, whereas in Britain, since 1980, 23 people have been convicted of insider dealing; more than 300 have been investigated by the Department of Trade and Industry (DTI) and 50 prosecuted.<sup>123</sup>

There are various reasons for this 'superior hit rate':<sup>124</sup> "Neither the COB nor the SEC has to resort to criminal law; both rely first on civil law, though the guilty may be charged with criminal offences as well. The burden of proof in civil disputes is less than in criminal ones. And the fines levied can be hefty. Besides forcing wrongdoers to give back their ill-gotten gains, both the COB can fine convicted insiders a multiple of those profits - up to three times the gains from transactions in America (though the SEC normally settles for less), and up to ten times in France."<sup>125</sup>

The lack of definite, harmonised penalties is among the main weaknesses of the Directive and it may obstruct EC legislation in achieving a common insider regulation within the EU, as well as, in providing Member States with the proper means of enforcing their insider dealing statutes.<sup>126</sup>



## 6. Enforcement and Co-operation between Member States

According to Article 8 (1) of the Directive each Member State shall designate the administrative authority or authorities competent, if necessary in collaboration with other authorities to ensure that the provisions adopted pursuant to this Directive are applied and shall so inform the Commission which in turn informs the other Member States. It would be impossible, in the absence of monitoring authorities, to discover the dealings of insiders and the perpetrators. The competent authorities must be given all *supervisory and investigatory powers* that are necessary for the exercise of their functions, where appropriate in collaboration with other authorities [Art 8 (2)]. In the statement of its motives the Commission underlines that the authorities should have sufficient powers of investigation to find out from financial intermediaries the real givers of orders.<sup>127</sup> This ambitious objective presupposes that national authorities are vested with sufficient powers of investigation and of sanction towards persons who would refuse to co-operate with them.<sup>128</sup>

The competent authorities shall co-operate with each other whenever necessary for the purpose of carrying out their duties, making use of the powers given to them. To this end, they shall exchange any information required for that purpose, including information related to actions prohibited according to the options of a more stringent prohibition under Articles 5 and 6 only by the Member State requesting the information [Article 10 (1)]. This means that a State cannot refuse to give information on the basis of the fact that the suspected behaviour is not considered insider dealing under its law.<sup>129</sup>

The competent authorities may refuse to act on a request of

information where the communication of the information might adversely affect the sovereignty, security or public policy of the State addressed, and where with respect to the same actions and the same persons, judicial proceedings have been initiated or final judgements have been passed [Article 10 (2)].

Article 10 (3) restricts the possible use of information given only to the exercise of the function of insider law enforcement and to the context of administrative or judicial proceedings specifically relating to the exercise of those functions. This is obviously an attempt to entrench the information given by tax authorities. Judicial proceedings under criminal law are treated differently. In addition the authority receiving the information may use it for other purposes if the competent authority communicating the information consents thereto. A duty of *professional secrecy* is imposed [Article 9] on all persons employed or formerly employed by the competent authority. Information covered by professional secrecy may not be divulged to any person or authority except by virtue of provisions laid down by law. This is another attempt to keep the information with the insider law enforcement authority. According to Hopt, neither mere administrative practice of information exchange nor the general laws about mutual assistance by the various public authorities should be considered to meet the requirement of Article 9 (2).<sup>130</sup>

The Community may, in conformity with the treaty conclude agreements with non-member countries on the matters governed by the Directive [Article 11]. Until it will have concluded such agreements, the Member States will be competent, according to the Council protocol<sup>131</sup>, to do so, provided the Directive is not affected and the agreement is not hindering the development of the Community law.

In the absence of a Community rule governing a particular subject



concerned, Member States will apply (after its entry into force) the *Convention on Insider Trading* of the Council of Europe (Article 16bis, inserted in the Convention by its Protocol of 11 September 1989), which will also be the essential source for international enforcement activities with respect to non-EC Member States.

According to Article 2 of the Convention, the Parties undertake to provide each other with the greatest possible measure of mutual assistance in the exchange of information relating to matters establishing or giving rise to the belief that irregular operations of insider trading have been carried out, in accordance with the specific rules laid down in the Convention. Each Party may, by a declaration to the Secretary General of the Council of Europe, undertake to provide other Parties, subject to reciprocity, with the greatest possible measure of mutual assistance in the exchange of information necessary for the surveillance of operations carried out in the organised stock markets which could adversely affect equal access to information for all users of the stock market or the quality of the information applied to investors in order to ensure honest dealing [Article 3 of the Convention]. The Parties also undertake to afford each other the widest measure of mutual assistance in criminal matters relating to offences involving insider trading [Article 12 (1) of the Convention].

## **7. Conflicts of Laws issues**

Recent experience has shown that insider dealing is becoming more and more an international problem.<sup>132</sup> The phenomenon of insider operations occurs more frequently in more than one countries. If the order for the purchase or the sale passes through a place other than the one where the securities are negotiated, if the person involved in the

transaction has his domicile in a different country, or if the securities in question have been admitted in more than one stock-exchange, the authorities of more than one states have the jurisdiction to control the illicit transaction.<sup>133</sup>

The Commission has made an effort to tackle problems of international private law, apart from international procedural law questions as mentioned above. According to Article 5 (1) each Member State shall apply the prohibitions provided for in Articles 2, 3 and 4, at least to actions undertaken *within its territory* to the extent that the transferable securities concerned are admitted to trading on a market of a Member State. The Community approach is based on a *territoriality principle*. This leads to the protection not only of the Member State's own markets, but also of all stock-exchanges and capital markets within the Community. This solution legitimises a plurality of competences (*cumul de compétences*) and gives to Member States the possibility of maintaining the already existing rules.<sup>134</sup>

Sentence 2 of Article 5 clarifies the content of the rule in sentence 1 by stating that each Member State shall regard a transaction as carried out within its territory if it is carried out on a market, as defined in Article 1 (2) *in fine*, situated or operating within that territory. The location of the place of operation and functioning may not be so self evident any more. The advent of modern computer-aided or even computer-driven markets creates the possibility that the latter may have 'more than one place of operation and functioning with the consequence that also more than one jurisdiction will be competent'.<sup>135</sup> In the draft directive there was the provision for transactions outside a stock exchange market. In that case the domicile of the counterparty of the professional insiders should be decisive.<sup>136</sup> This provision was modelled on consumer protection rules



and was dropped in the final version. The problems that may occur will have to be answered by the general conflict of law provisions of Member States.<sup>137</sup>

## 8. Appraisal

The Directive is an attempt to provide minimum standards for insider dealing laws throughout the Community. Its efficiency will depend, to a great extent, upon the legislative measures that Member States will take in order to adopt the Directive's rules into their national laws. But under one provision: It has become a well-accepted principle determined by the European Court of Justice, that national courts of the Member States should comply with that Directive to the extent that it is clear and does not give discretion to Member States about its implementation even where the national legislation is either non-existent or defective.<sup>138</sup> In the extreme case of *Marleasing SA v La Comercial Internacional de Alimentacion SA*<sup>139</sup> national courts were required to ignore altogether national legislation which is in conflict with the terms of the Directive.<sup>140</sup>

Among the major strengths of the Directive are the definitions of the terms. The definition of insider, for example, provides an excellent basis because it is broad and may include persons other than those directly connected with the company, such as lawyers, auditors, and financial journalists. Other Directive terms, such as employment, duties, and profession, are defined precisely and, therefore should escape judicial manipulation.<sup>141</sup> The definition of inside information is broad yet clearly defined. The Directive would be stronger if all restrictions applied to primary insiders were also applied to tippees. On the other hand, in those countries where secondary insiders will not be submitted to the tipping

prohibition, their distinction from the third category of primary insiders will be important, but create problems of delineation. Certain professional groups (such as investment analysts), if they are treated like primary insiders, will be restricted in the free exercise of their profession. It would have been advisable to clearly state explicit exceptions from the general rule, as was done for certain categories in the preamble.<sup>142</sup>

Another strength of the Directive is its scope. The Directive applies not only to transactions undertaken on a stock exchange, but also to any transaction involving a professional intermediary. It can reach transactions with securities registered on a stock exchange which are not traded on the exchange, as well as transactions that do not involve a professional intermediary.<sup>143</sup>

The Directive provides an express legal basis to justify actions against inside traders. Resort to general principles and unrelated provisions of securities fraud is no longer necessary, contrary to the situation in the U.S.A.

The stage of prosecution of violations poses special problems since the prohibition includes a large number of persons traditionally considered as outsiders and requires that these persons act *scienter* and that there be a causal connection between their "full knowledge of the facts" and their act. As has been shown, in most cases the Directive imposes a rebuttable presumption of knowledge on primary insiders. The latter bear, consequently, the burden of proof of their ignorance or the lack of connection between their decision to transact and their specific knowledge. In 10 out of 12 Member States with Civil Law systems no presumptions or presumed truths can exist in Criminal and Criminal Procedural Law. In other words, the creation of a level playing field in relation to the burden of proof seems impossible. Apart from the problems



of proof that the Directive creates, even more difficulties will arise when it comes to defining the exact content of the "*full knowledge of the facts*".

The Directive tries to integrate the preventive aspect of mandatory disclosure of information. Article 7 extends the *timely disclosure* provision of the first Stock Exchange Admission Directive of 1979<sup>144</sup> to companies and undertakings the transferable securities of which, whatever their nature, are admitted to trading on an official market. This provision states the obligation for companies-issuers of securities to immediately inform the public about circumstances likely to affect significantly the price of their transferable securities. The consequences of this apparently minor extension of the disclosure of information obligation may be considerable for the Member States.<sup>145</sup>

The measures of the Directive do not deal sufficiently with the problem of insider dealing in the context of take-overs and banking. The Commission is currently furthering its efforts to cover take-over bid regulation.<sup>146</sup> Hopt suggests that the Directive can be the point of departure for insider law harmonisation but there is room for improvement in the context of many financial operations, even outside the securities market, particularly in universal or all purpose banking systems, where dealings of insiders could also be regulated by a special bank contract law or a bank supervisory law.<sup>147</sup>

The Directive is also incomplete in enforcement and surveillance measures. The detection of violations presents one of the most important problems related to the regulation of insider trading. The addition of an institutional level surveillance requirement, so as to create in each Member State regulatory bodies similar to the American Securities and Exchange Commission (SEC), would improve greatly the effectiveness of the Directive.

The original Commission proposal left the penalties for violation of insider trading to the discretion of each Member State. The adopted version provides that the penalties must be "sufficient to promote compliance with those measures".<sup>148</sup> Although the Directive is an improvement over the first proposal and can be characterised as a realistic political compromise, harmonisation of sanctions provides a better approach and, more importantly, one in conformity to the regulatory purpose pursued.<sup>149</sup> The primary goal of the Directive, which is fostering investor confidence in the EC securities market, will not be met. Penalties that are not harmonised, instead of safeguarding the successful and fair operation of the market, have an erosive influence on investor confidence. The discretion of Member States to determine the penalties for infringement of the prohibitions gives rise to the question whether the mere adoption of criminal penalties is an effective implementation of the Directive or civil remedies could provide a necessary and probably more efficient alternative. The Directive, in other words, does not furnish any guidelines as to the form sanctions should take, apparently ignoring the criticism on the deterrence potential of criminal law and the possibility of substituting civil remedies or combining civil and criminal sanctions.<sup>150</sup>

In contrast with the discretion afforded by the Directive as far as national enforcement and sanctions are concerned, mutual co-operation and information exchange between Member States' authorities is expressly required. This solution seems convincing both in pragmatic terms and on an international law level.<sup>151</sup>

Bergmans has expressed concern that the regulation of insider dealing was not seen in the general context of the harmonisation of company law and securities regulation, as an aspect of a 'wider policy goal linked to the Single Market of 1992, and in particular a Common Capital



Market in the context of a continuing globalisation of this area'.<sup>152</sup> The above commentator is in favour of a more balanced approach which would take under consideration, apart from the proper functioning of the market as the only policy argument, the interests of certain categories of participants of the securities markets.<sup>153</sup>

On the other hand Bergmans' suggestion that reference should be made by the Directive to problems of breach of duty and misappropriation of information is not in conformity with the spirit of the Directive and the shift of emphasis from the traditional company law - fiduciary approach to that of securities market regulation it attempts.<sup>154</sup> Information, however, should be recognised as the central element to be regulated. It has been correctly argued that insider dealing is also a problem of asymmetries of information.<sup>155</sup> It would be advisable, therefore, that national legislators use the law of information as a general legal framework for the Directive's rules.

## 9. Conclusion

The EC Directive on Insider Dealing, being a compromise text, has not always adopted desirable solutions. It reflects, however, the widespread understanding among Member States that rigorous action must be taken to combat the expansion of insider dealing practices.<sup>156</sup> By adopting the present Directive, the EC takes a positive step towards harmonising the insider dealing laws of EC States.

The efficiency of the Directive depends greatly on the severity of sanctions that will be enacted in the Member States. In order to achieve harmonisation and to encourage the co-operation between the authorities of different Member States the Directive has extended the competence of

the Contact Committee, which was instituted by Article 20 of the Directive 79/279/EEC co-ordinating the conditions for the admission of securities to official stock exchange listing, to the cases of insider dealing. The Contact Committee 'shall also have as its function: (a) to permit regular consultation on any practical problems which arise from the application of this Directive and on which exchanges of view are deemed useful; (b) to advise the Commission, if necessary, on any additions or amendments to be made to this Directive.'<sup>157</sup> Beyond these procedures, it can be reasonably assumed that the concern of financial centres to reassure investors will exercise enough pressure on Member States towards vigorous sanctioning of insider dealing.

## NOTES

<sup>1</sup> *Official Journal of the European Communities*, No. L 334/30

<sup>2</sup> Bernhard Bergmans, *Inside Information and Securities Trading: A Legal and Economic Analysis of the Foundations of Liability in the USA and European Community*, 1991 Graham & Trotman Ltd, p. 69

<sup>3</sup> Klaus Hopt, "The European Insider Dealing Directive", *Common Market Law Review*, 27:51-82 (1990), p61, also published in *European Insider Dealing - Law and Practice*, editors: Klaus Hopt & Eddy Wymeersch, KLUWER 1991, pp 129-149.

<sup>4</sup> Bernhard Bergmans, *supra* note 2, Hopt, *supra* note 3 and others

<sup>5</sup> Hopt, *supra* note 3

<sup>6</sup> Bergmans, *supra* note 2

<sup>7</sup> *supra* note 1

<sup>8</sup> Rapport annuel 1976, p. 9, quoted by E. Gaillard & I. Pingel, "Les opérations d'initiés dans la Communauté économique européenne", *Revue Trim. Dr. Europ.* 26(2) avr.-juin 1990, pp. 329-355

<sup>9</sup> *idem* p70

<sup>10</sup> Hopt, *supra* note 3, p. 62

<sup>11</sup> Art. 10-1, ordonnance of 28 September 1967,



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<sup>12</sup> E. Gaillard & I. Pingel, "Les opérations d'initiés dans la Communauté économique européenne", *Revue Trim. Dr. Europ.* 26(2) avr.-juin 1990, pp. 329-355, p.337

<sup>13</sup> *idem*

<sup>14</sup> *idem*

<sup>15</sup> The ordonnance of 28 September 1967 imposes to the same *mutatis mutandis* group of company insiders an irrebuttable presumption of knowledge of the facts. It is sufficient that the persons concerned operated in the market. In other words these persons can not prove their ignorance of the information.

<sup>16</sup> *supra* note 1, Art 2(1), "*en connaissance de cause*" in the french version

<sup>17</sup> *idem*

<sup>18</sup> E. Gaillard & I. Pingel, *supra* note 12

<sup>19</sup> Hopt, *supra* note 3, p 63

<sup>20</sup> Companies Act 1985, ss 198 to 220, Pennington's Company Law, sixth edition, Butterworths 1990, p. 362, cf. Securities Exchange Act 1934, section 16(a),

<sup>21</sup> E. Gaillard & I. Pingel, *supra* note 12, p.339

<sup>22</sup> Hopt, *supra* note 3, p. 65

<sup>23</sup> *idem*

<sup>24</sup> Bergmans, *supra* note 2, p. 85

<sup>25</sup> E. Gaillard & I. Pingel, "Les opérations d'initiés dans la Communauté économique européenne", *Revue Trim. Dr. Europ.* 26(2) avr.-juin 1990, pp. 329-355

<sup>26</sup> Bergmans, *supra* note 2, p. 85

<sup>27</sup> E. Gaillard & I. Pingel, *supra* note 25, pp. 339-340, and note 3, p. 63

<sup>28</sup> Hopt, *supra* note 3, p. 63

<sup>29</sup> Art. 2 No. 1 lit. d of The German Insider Trading Guidelines, cited by Hopt *supra* note 3, p63

<sup>30</sup> This interpretation is proposed by Hopt *supra* note 3, p63

<sup>31</sup> *idem*

<sup>32</sup> Hopt, *supra* note 3, p. 64

<sup>33</sup> *idem*

<sup>34</sup> *idem*

<sup>35</sup> *idem*

<sup>36</sup> Bergmans supports that the tipper must not necessarily be aware of the "inside" status of the information, although, he concedes, it is difficult to see the underlying rationale for imposing a stricter liability on a tipper than on a trader. *supra* note 2 at pp. 87-88.

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- 37 Hopt, supra note 3, p. 70
- 38 E. Gaillard & I. Pingel, supra note 12, p. 345
- 39 Bergmans, supra note 2, p. 88
- 40 supra note 1, Art. 4
- 41 supra note 1, Art. 6
- 42 Bergmans, supra note 2, p.88 where Hübscher .....p. 335 cited: if a security analyst writes a report on a company on the basis of unpublished information, which is then communicated by his employer to a client who trades on the basis of that report, who would incur liability?
- 43 Hopt, supra note 3, p. 70
- 44 idem, see footnote 39,
- 45 idem, at p.61, also quoted by Bergmans supra note 2, at p.88, Preamble of the Insider Dealing Directive
- 46 Hopt, idem at p. 71
- 47 Bergmans, supra note 2, pp. 85-86
- 48 Hopt cites at supra note 3, at p. 72 the case of an industrial spy. Bergmans observes on this particular occasion that the spy should not steal information professionally, at supra note 2, at p. 86. footnote 24
- 49 Bergmans, supra note 2, p. 86
- 50 Hopt, supra note 3, p. 71
- 51 Bergmans, supra note 2, p. 86
- 52 Art 6
- 53 Hopt, supra note 3, p. 71
- 54 Bergmans points out that cleaning personnel, taxi drivers and others are not usually active securities traders, supra note 2
- 55 Bergmans, supra note 2, at p.71
- 56 Michael Ashe, "The Directive on Insider Dealing", *The Company Lawyer*, Vol 13 No1 p.17
- 57 Bergmans, supra note 2, at p. 72, note 24: "The original proposal used the terms 'information unknown to the public', the amended proposal 'information inaccessible or not available to the public' (Article 6). The German version of the Directive uses the terms 'nicht öffentlich bekannt', i.e. not publicly known.
- 58 Hopt, supra note 3, at p. 58
- 59 idem



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- <sup>60</sup> According to the Preamble to the Directive its objective is to place investors on an equal footing, see Michael Ashe *supra* note 56, at p. 17
- <sup>61</sup> Hopt, *supra* note 3, at p. 58
- <sup>62</sup> Ashe, *supra* note 56, at p. 17
- <sup>63</sup> Bergmans, *supra* note 2, at p. 72
- <sup>64</sup> Hopt, *supra* note 3, at p. 58
- <sup>65</sup> *idem*
- <sup>66</sup> Ashe, *supra* note 56, p. 17, where reference is made to *SEC v Texas Gulf Sulphur Co* 401 F 2d 833
- <sup>67</sup> for case law on the problems of interpretation posed by the terms 'precise nature' see Ashe *supra* note 56, p. 16
- <sup>68</sup> Hopt, *supra* note 3, p. 60
- <sup>69</sup> Ashe, *supra* note 56, p. 17
- <sup>70</sup> Gaillard & Pingel, *supra* note 12, p. 335, Com (87) 111 final, *préc*, (21 May 1987), p. 5
- <sup>71</sup> *idem*, Gaillard & Pingel illustrate this distinction with examples from the French '*jurisprudence*', at p. 5
- <sup>72</sup> Gaillard & Pingel, *supra* note 12, p. 336
- <sup>73</sup> Hopt, *supra* note 3, p. 59
- <sup>74</sup> Com (87) 111 final, *préc*, (21 May 1987), p. 5
- <sup>75</sup> Hopt, *supra* note 3, p. 59
- <sup>76</sup> *idem*
- <sup>77</sup> Gaillard & Pingel, *supra* note 12, p. 336
- <sup>78</sup> Hopt, *supra* note 3, p. 60
- <sup>79</sup> *idem*, also Bergmans, *supra* note 2, p. 73
- <sup>80</sup> *supra* note 1
- <sup>81</sup> M. Schödermeier & E. Wallach, "The EEC Insider Directive Approaching Final Adoption", *Journal of International Banking Law*, 1989, p. 236
- <sup>82</sup> Hopt, *supra* note 3, p. 66
- <sup>83</sup> *idem*
- <sup>84</sup> *idem*
- <sup>85</sup> Bergmans, *supra* note 2, p. 74, footnote 32
- <sup>86</sup> Hopt, *supra* note 3, p. 67, where he remarks that: 'under the Directive all segments of stock exchange trading are covered, not only the official listing (*amtlicher Handel*), but also the regulated market (*geregelter Markt*) and the free trade allowed under the roof and

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the directives of the stock exchange.(*Freiverkehr*).

<sup>87</sup> *Börsenzeitung* of 5 November 1987, at 15 onward, cited by Schödermeier & Wallach supra note 81 at p. 236

<sup>88</sup> Ashe, supra note 56, p. 18

<sup>89</sup> Hopt, supra note 3, p. 67

<sup>90</sup> Art. 2 of the draft directives of 25 May 1987 and 4 Oct. 1988. These draft directives required the element of scienter only in Art. 3(1) for tippees.

<sup>91</sup> Gaillard & Pingel, supra note 12, p. 342, it should be noted that Art. 10-1 of the French Ordonnance requires "scienter" only if someone knowingly lets someone else trade on the basis of inside information, and appears to be, therefore, much stricter than the Directive.

<sup>92</sup> Hopt, supra note 3, p. 68

<sup>93</sup> idem

<sup>94</sup> Bergmans, supra note 2, p. 87

<sup>95</sup> Hopt, supra note 3, p. 67 .

<sup>96</sup> Bergmans, supra note 2, p. 87

<sup>97</sup> item 1, p. 2

<sup>98</sup> Hopt, supra note 3, p. 68, "It is true that the theoretical difference between criminal offences and quasi-criminal irregularity is a fine one, but in practice this makes it possible to reach the corporate actor and not only its organs, which may change or hide or not be the right persons to be subject to civil law sanctions."

<sup>99</sup> Bergmans, supra note 2, p. 75

<sup>100</sup> end of item 3, p. 19

<sup>101</sup> Bergmans, supra note 2, p. 74

<sup>102</sup> Hopt, supra note 3, p. 69

<sup>103</sup> Mainly Germany, Netherlands

<sup>104</sup> Hopt, supra note 3, p. 68

<sup>105</sup> Hopt, supra note 3, p. 69

<sup>106</sup> idem

<sup>107</sup> idem

<sup>108</sup> Gaillard & Pingel, supra note 12, p. 334

<sup>109</sup> idem

<sup>110</sup> Hopt, supra note 3, p. 70

<sup>111</sup> Gaillard & Pingel, supra note 12, p. 345

<sup>112</sup> Hopt, supra note 3, p. 69



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- 113 item 1(b)
- 114 *Official Journal* 1988, C 187/93
- 115 Art 11 of the draft directive of 4 Oct. 1988, Com (88), 549 préc.
- 116 Sec (89) 1207 final, préc., p. 6.
- 117 Amy E. Stutz, "A New Look at the European Economic Community Directive on Insider Trading", *Vanderbilt Journal of Transnational Law*, Vol. 23:1:99
- 118 Bergmans, supra note 2, p. 89
- 119 some presented in chapter A, see also Frank Lorenz, "Control of Insider Dealing in Germany: Proposed Reform", *Journal of International Banking Law*, [1993] 8, pp. 318-322
- 120 Bergmans, supra note 2, p. 89
- 121 Hopt, supra note 3, p. 76, also cited by Bergmans supra note 2, p. 90
- 122 Bergmansn supra note 2, p. 91
- 123 "Turking insider-traders out", *The Economist*, July 16th-22nd, 1994, pp. 79-80
- 124 idem
- 125 idem
- 126 for an appraisal of the efficiency of Criminal Sanctions see: J. M. Naylor, "The Use of Criminal Sanctions by UK and US Authorities for Insider Trading: How Can the Two Systems Learn from Each Other?", Part I, *The Company Lawyer*, Vol. 11, No. 3, pp. 53-61
- 127 Com (87) 111 final, préc., p. 10
- 128 Gaillard & Pingel, supra note 12, p. 347
- 129 Bergmans, supra note 2, p. 77
- 130 Hopt, supra note 3, p. 77
- 131 Declaration of the Commission for the Council Protocol No. 9 concerning Article 11
- 132 Schödermeier & Wallach, supra note 81, p. 237
- 133 Gaillard & Pingel, supra note 12, p. 348
- 134 idem, p. 349
- 135 Hopt, supra note 3, p. 79
- 136 Art. 1 (1) third para. of the draft directives of 1987 and 1988,
- 137 Hopt, supra note 3, p. 79
- 138 J. Murray, "The new insider dealing law: a critique", *Insider Dealing - Papers presented at a seminar*, Edinburgh, 27 August 1993, edited by H. L. MacQueen, The David Hume Institute, p. 20
- 139 [1990] 1 ECR 4135
- 140 J. Murray, supra note 138, p. 20

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- <sup>141</sup> Stutz, *supra* note 117, p. 168, *contra*: Bergmans, *supra* note 2, at p. 93
- <sup>142</sup> Bergmans, *supra* note 2, p. 93
- <sup>143</sup> Stutz, *supra* note 117, p. 169
- <sup>144</sup> Schedule C.5(a) of the Annex of the Directive, *Official Journal* 1979, L66/21
- <sup>145</sup> Hopt, *supra* note 3, p. 81
- <sup>146</sup> *Official Journal* 1989, C 64/8, Draft Directive of February 1989
- <sup>147</sup> Hopt, *supra* note 3, p. 82
- <sup>148</sup> Directive, *supra* note 1, Article 13
- <sup>149</sup> Stutz, *supra* note 117, p. 81
- <sup>150</sup> J Naylor, 'The Use of Criminal Sanctions by the UK and the US Authorities for Insider Trading' (1990) 11 *Company Lawyer*, p. 53
- <sup>151</sup> Hopt, *supra* note 3, p. 81
- <sup>152</sup> Bergmans, *supra* note 2, p. 95
- <sup>153</sup> *idem*
- <sup>154</sup> P. L. Davies, 'The EC's Directive on Insider Dealing: From Company Law to Securities Markets Regulation?', *Oxford Journal of Legal Studies*, vol. 11, no. 1, Spring 1991, pp. 92-105, see INTRODUCTION
- <sup>155</sup> Hopt, *supra* note 3, p. 82
- <sup>156</sup> Schödermeier & Wallach, *supra* note 81, p. 238
- <sup>157</sup> *supra* note 1, Insider Dealing Directive 89/592 Article 12



## D. 1. Insider Dealing Regulation in the United Kingdom

### Recent Developments

#### Introduction

The United Kingdom first introduced prohibitions against insider trading in the Companies Act of 1980.<sup>1</sup> The philosophy behind the legislation was to *'develop the confidence of small investors by providing them with a feeling of protection from the unscrupulous'*.<sup>2</sup> This legislation was re-enacted with modifications in 1985 in the Company Securities (Insider Dealing) Act 1985. The 1985 Act increased criminal sanctions and included provisions relating to insider trading in the context of take-overs and mergers. The rapid development of the securities markets throughout the 1980s necessitated further legislative reform in order to promote the efficiency and competitiveness of the financial services industry. In 1986 the insider trading law was amended by the Financial Services Act 1986 which was primarily concerned with the general regulation of the financial services industry but, nevertheless, had implications for the control of insider trading. In addition to these provisions, it was thought *'desirable to maintain the flexibility which exists in a self-regulatory framework'*<sup>3</sup>. Accordingly, there existed a number of self-regulatory organisations ('SROs') established under the Financial Services Act 1986 that drew up their own Codes of Conduct. The Securities and Investments Board ('SIB') and the various SROs were responsible for the promulgation of the Conduct of Business Rules and Core Rules. The Panel on Take-overs and Mergers was responsible for the promulgation and supervision of the City Code on Take-overs and Mergers ('City Code') and, finally, the Model Code for Securities Transactions by Directors of Listed Companies ('Model Code') which was

drawn up by the Council of the Stock Exchange, set out guidelines for dealings by directors in the shares of their own company where that company is a listed company. The Model Code was annexed to the Admission of Securities to Listing ('Yellow Book').

On May 6, 1997, the Chancellor of the Exchequer announced that responsibility for monetary policy was being transferred to the Bank of England. This would necessitate legislation, and on May 20, 1997 he announced that he was taking the opportunity to tackle the question of regulatory reform.<sup>4</sup> In a passage that contains the heart of the matter he said:

*'So there is strong case in principle for bringing the regulation of banking, securities and insurance together under one roof. Firms organise and manage their businesses on a group-wide basis. Regulators need to look at them in a consistent way. This would bring the regulatory structure closer into line with the day's increasingly integrated financial markets. It would deliver more effective and more efficient supervision, giving both firms and customers better value for money.'*

As a key feature of the reforms, the principle of self regulation was in effect abandoned, being replaced by an independent agency based on the existing SIB, and operating under statutory authority with an indeterminate degree of practitioner involvement. In all, nine regulatory bodies were to be subsumed, namely the Building Societies Commission, the Friendly Societies Commission, the Insurance Directorate of the DTI, the Investment Management Regulatory Organisation (IMRO), the Personal Investment Authority (PIA), the Registry of Friendly Societies, the Securities and Futures Authority (SFA), the Securities and Investments Board (SIB), and the Supervision and Surveillance Division of the Bank of England.

The new regulator was launched by its incoming Chairman, Howard



Davies, on October 28, 1997. Legally, it was the SIB, re-named the Financial Services Authority (FSA). FSA will become fully operational by the end of 1999. Its remit covers banking, securities and insurance supervision.<sup>5</sup> Standards of supervision will certainly be more consistent. One central location and organisation will encourage prompt and frequent exchange of information amongst the individual units or departments, but there must be some doubt, until otherwise proven, of the appropriateness of the supervision to all types of financial services businesses. Enforcement will be consistent and probably more rigorous, creating a wider gulf between the regulator and the regulated. More personal accountability of the most senior executive in a financial institution will highlight this notion and lead to a more litigious approach by the regulated.<sup>6</sup>

Critics such as Michael Taylor, a former Bank of England official, claim that the FSA's remit is too wide to be effective<sup>7</sup>, suffering from *'management overstretch, an impossibly broad range of responsibilities .... conflicting cultures ... a lack of accountability and oversight.'* The Director of the Serious Fraud Office highlighted the fact that the legal framework of the FSA will need radical amendment because at present the SIB, unlike the other SROs, does not have the power to fine traders or financial advisers who break the rules.<sup>8</sup> Howard Davies himself has called on the government to grant the FSA the power to impose civil penalties on insider dealers, claiming that the power to name and shame individual offenders is insufficient.<sup>9</sup>

The FSA's investigation, enforcement and disciplinary work will be carried out by a dedicated unit. The present situation whereby firms are subject to different disciplinary powers depending upon their choice of regulator will cease.<sup>10</sup>

At present, the biggest failing in the British system is the *'sorry record*

*of enforcement*'.<sup>11</sup> According to the same commentator the stock exchange has a better record of spotting possible insider dealing than in America or France; but the prosecution authorities find it harder to achieve successful prosecutions than their American or French counterparts.<sup>12</sup> Some 'grumblers' have even argued that the notion of self-regulation within a statutory framework which underpinned the 1986 Financial Services Act has failed and that 'full-blown statutory regulation, anathema in 1986, would be preferable'.<sup>13</sup> Regulatory reform is all very well, but is pointless if the rules are not enforced. British fraud investigators have a miserable recent conviction rate - notably in such high-profile cases as Blue Arrow and Guinness. As regards insider dealing, it is quite remarkable that, since 1980, 23 people have been convicted of insider dealing, more than 300 have been investigated by the DTI and 50 prosecuted. Only in 1993, of the seven people prosecuted none was convicted. In other words, the most urgent reform must be to improve the detection and prosecution of rule-breakers.<sup>14</sup>

From the prosecution point of view the Company Securities (Insider Dealing) Act 1985 created an offence that contained many separate elements, all of which had to be proved<sup>15</sup>, increasing, thus, the opportunities 'for the prosecution case to come to grief for technical evidential reasons'.<sup>16</sup> This view is apparently shared by Professor Gower<sup>17</sup> who claimed that the old legislation, by its proliferation of matters that had to be proved and of defences that might be raised, seemed calculated to make it as difficult as possible for the criminal law sanctions against insider dealing to be effective, and expressed the hope that the situation would be improved if legislation in compliance with the EC Directive were adopted.



## The New Law

The EC Council Directive of 13th November 1989 co-ordinating regulations on insider dealing (89/592/EEC OJ L 334/30) required the adoption by Member States of insider dealing legislation in compliance with its terms before 1st June 1992. The United Kingdom exceeded the EC deadline by a little over a year. The Criminal Justice Act 1993 in implementing the EC Insider Dealing Directive brought about significant changes of the law mainly by extending potential criminal liability.

The fact that the EC Directive is the source of the British legislation has a two-fold importance which should be noted at this point: (a) It has become an accepted principle by the European Court of Justice and, with understandable reluctance, by national courts that Member States should comply with EC Directives to the extent that they are clear and they do not give discretion to Member States about their implementation 'even where the national legislation is either non-existent or defective'.<sup>18</sup> In the extreme cases *Marleasing SA v La Comercial Internacional de Alimentacion SA* [1990 1 ECR 4135] or *M. Karella and N. Karellas v Minister of Industry, Energy and Technology* [1993 BCC 677] national courts were required to ignore national legislation which was in conflict with a Directive.<sup>19</sup> (b) The legislative steps taken in compliance with an EC Directive should be also construed in the light and the context of the Directive so as to serve the same purpose.<sup>20</sup>

The new statutory provisions contained in the Criminal Justice Act 1993 are differently worded from their predecessors but are nevertheless just as complex. A careful examination of a number of definitions is required for the better understanding of the provisions.

## I. Insiders

The Criminal Justice Act 1993 does not use the terms "*primary*" insider and "*secondary*" insider (or "*tippee*"<sup>21</sup>), but they are widely used in practice, they have been endorsed by the House of Lords<sup>22</sup> and they correspond to the approach of the Act which uses the concept of having information "*from an inside source*"<sup>23</sup> defining exhaustively<sup>24</sup> "*inside source*" as having the information either by virtue of status (i.e. being a primary insider) or from a primary insider (i.e. being a secondary insider or tippee).<sup>25</sup>

### a) Primary insiders

Under Article 2 of the Directive, three categories of persons who possess inside information are to be prohibited by Member States from dealing in the securities to which that information relates. They are persons who possess inside information:

- (i) by virtue of their membership of the administrative management or supervisory body of the issuer of transferable securities;*
- (ii) by virtue of their holding in the capital of the issuer of such securities; or*
- (iii) because they have access to such information by virtue of the exercise of their employment, profession or duties.*

The third category is the broadest. It encompasses as primary insiders all those who have access to inside information of a company by virtue of their status. The test has been characterised by Rider and Ashe as 'wholly subjective and depending on whether a person has access to inside information and if he does whether it is by virtue of his position'<sup>26</sup>, which may be because of the absence of any well-defined criterion.<sup>27</sup> The circle of potential insiders embraces, thus, not only the employees of the company itself but also persons such as bankers, auditors, lawyers and others who, 'though not a part of the company, are close to it'.<sup>28</sup>



Part V of the Criminal Justice Act 1993 (hereinafter the 'Act') provides that an insider is a person who has information from an inside source either:<sup>29</sup>

*through:*

*(i) being a director, employee or shareholder of an issuer<sup>30</sup> of securities; or*

*(ii) having access to the information by virtue of his employment, office or profession.*

This definition replaces the notion of a person 'knowingly connected with a company' under s. 9 of the Company Securities (Insider Dealing) Act 1985 and those abusing information obtained in an official capacity (s. 2 of the Act).<sup>31</sup> What seems to be important now is not the connection<sup>32</sup> with the company but the access to inside information and the quality of the information as inside information which originates from an inside source. This solution is probably related to the shift of emphasis in the philosophy underlying European Insider Trading Laws as explained by Davies.<sup>33</sup> In other words, the regulation of relationships in the securities markets seems to be the objective of the Act and not, as previously, the regulation of relationships characterized by common law as having a fiduciary character.<sup>34</sup> The approach of the Act and, specifically, the 'loosening' of the connection with the company has been criticized as making the offence 'too wide'.<sup>35</sup> Moreover, if the breach of trust by individuals 'connected' with the company was formerly accepted as the philosophical basis for making this behaviour a criminal offence the new law reduces the credibility of this argument. According to Janet Dine<sup>36</sup> the formulation of the Act 'may catch the waiter who gleans the information from overheard conversation as he serves a meal to insiders since he gains the information by virtue of his employment'.

It could be argued, however, that the wording of the Act establishes a *causal* link between the employment or status and the acquisition of

information by requiring that a person has information from an inside source 'if and only if' he has it '*through having access by virtue of*' the employment etc. The wording of the Act is stronger than that of the Directive which simply uses the term '*by virtue of*'.<sup>37</sup> On the other hand, according to the Act it is no longer necessary to show that the employee occupied a position which could reasonably be expected to give him access to inside information. According to Davies 'if the broader "*but for*" test is adopted, then employees of these organisations, not employed on the tasks mentioned, but who *serendipitously* [emphasis added] come across the information in the workplace, would be covered too.'<sup>38</sup> The wording of both texts is still ambiguous and whether it expresses the necessity for a casual link may fall to be determined by a preliminary ruling of the European Court of Justice at some future date.<sup>39</sup>

The Act does not make specific provisions for "public servants"<sup>40</sup> or individuals contemplating take-over bids. The former case is certainly covered by the general terms of the new provision whereas the latter is rather redundant and has been omitted from the Act since it is normally corporations that make take-over bids.<sup>41</sup>

'*Automatic insider status*'<sup>42</sup> is also now conferred for the first time on shareholders. There is no theoretically lower threshold for the shareholding to be relevant to a prosecution, in the absence of any guidelines from the Directive. It is likely, as the Government recognised,<sup>43</sup> that this category of insider will be more appropriate to the larger or institutional shareholder who holds a significant block in the company. A typical example of such a case would be a shareholder who declines a secret approach to sell his stake to a potential bidder but nevertheless trades on the basis that a forthcoming bid for the company is likely to be made.<sup>44</sup>



According to the Act only individuals (or persons) can be insiders (ss.57(1) and 52). The idea of extending the scope of insider dealing law to cover legal entities as well as individuals had been considered but it was concluded that since companies act through individuals it would be 'an unnecessary complication to cover the actions of companies in general'.<sup>45</sup> It should be noted at this point that the Directive clearly contemplates that companies can be insiders but also expressly provides in Article 2(2) that when the status of insider is attributable to a legal person, the prohibition applies to the natural persons who decided to carry out the transaction for the account of the legal person concerned.

In the new law there is no specific provision for "*shadow directors*".<sup>46</sup> Such persons, however are likely to be "*secondary*" insiders.

#### **b) Secondary insiders**

A secondary insider or tippee is a person whose "*direct or indirect source of ... information*" is a primary insider.<sup>47</sup> Thus, anyone who has information emanating from a primary insider, no matter how long the chain of information is,<sup>48</sup> may be a secondary insider. Problems of proof, however, may arise the longer the chain becomes. The scope of the tippee liability is now broader. Under the old law, in the case of *R v. Kean and Floyd*<sup>49</sup> 'part of the successful defence case was that two market-makers in a dealing house which was corporate broker to a public company could not be tippees if they had received inside information about that company from their colleague, an in-house analyst, who knew from her boss about a pending announcement from the company but who had no relationship with that company personally'. The Crown had not proved that they received information from a person knowingly connected with that public company and the analyst was not 'shown to have been connected with the

public company at all'.<sup>50</sup> Such an argument will not stand under the 1993 Act because as Rider points out the '*sourcing*' of the information is much wider than under the 1985 Act.<sup>51</sup>

The new wording which avoids the use of the phrase "obtains [information]" lays to rest the controversy which has been settled in the prosecution's favour by Attorney General's reference (No. 1 of 1988)<sup>52</sup> of whether '*obtain*' connoted actively seeking out the information or, more broadly, just "coming into possession...without effort on one's own part".<sup>53</sup> The new wording makes it clear that a tippee may be such no matter how he acquired the information, as long as the original source was a primary insider.<sup>54</sup> The defendant must know that he '*has*' the information from a direct or indirect source who was an insider. It is now clear that unsolicited information is also covered.<sup>55</sup> In an *obiter*, rather over-restrictive comment in the same Reference, Lord Lowry indicated that a tippee could only be made liable under the 1985 Act if he knew the *identity* of his informant. The ambiguity on the exact knowledge which the tippee must possess continues both in the Directive and in the 1993 Act. In the wording of Article 4 of the Directive the tippee '*with full knowledge of the facts* possesses inside information, the direct or indirect source of which could not be other' than a primary insider.<sup>56</sup> According to s. 57 of the 1993 Act the tippee must know that he has inside information and, at the same time, that he has the information from an inside source. Section 57 also provides that the tippee has information from an inside source '*if and only if the direct or indirect source of his information is*' a primary insider. In both provisions it remains unclear whether the identity of the primary insider, who communicated the inside information, must be known. The Government's Consultation paper was rather clearer on the identity issue: 'It is not proposed that the secondary



insider [or tippee] need know exactly *which primary insider* was the source, but instead that he should know only that it came from a primary insider.<sup>57</sup> If the courts decide, however, to follow Lord Lowry's *obiter dictum*, they will unduly confine the scope of legislation which explicitly seeks to catch tippees whose indirect source is an insider. The knowledge of the specific and price-sensitive nature of the information should be the only *parameter* for tippee liability rather than the additional one set out by the legislation, *i.e.* the awareness of the identity or position of the immediate or ultimate informants of tippees.<sup>58</sup> Proving, however, 'that a "*sub-tippee*" or even a "*sub-sub-tippee*" knew that the ultimate source of the information was a primary insider could be fraught with problems.'<sup>59</sup>

## II. Inside Information

The definition of what amounts to inside information is probably the most significant innovation of the new Act. The general principle of the underlying philosophy is stated in the preamble to the EC Directive: investor confidence depends *inter alia* on the assurance afforded to investors that they are placed on an *equal footing* and that they will be protected against the improper use of inside information. The Criminal Justice Act 1993 states that (ss 56 & 60(4)) "inside information" means information which:

'(a) relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally;

(b) is specific or precise;

(c) has not been made public; and

(d) if it were made public would be likely to have a significant effect on the price of any securities.'

The possession of "inside information" is an essential requirement of liability under the statute. The definition of the term is inevitably complex and breaks down into four cumulative components. All four must be present for the information to be "inside information".<sup>60</sup>

First,<sup>61</sup> "inside information" means information which relates either to particular securities<sup>62</sup> (whereas the old law only talked about information relating to the "company"<sup>63</sup>) or to a particular issuer of securities<sup>64</sup> or to particular issuers of securities. The definition expressly provides that the information must not relate to securities "generally" or to issuers of securities "generally". Thus, it has to refer to a specific category of securities or issuers. Examples of such "inside information" would be information that a take-over bid for a company was imminent<sup>65</sup> or that the company's profits were out of line with expectation. Moreover it is expressly provided<sup>66</sup> that information is to be treated as relating to an issuer which is a company not only where it is about the company but also where it may affect the company's business prospects. This provision was inserted to make clear that information about the context in which a company operates is to be regarded as information about the company. Thus, for example, information about changes in the market sector a company belongs to, or about its main supplier will be comprised within the clause.

Secondly,<sup>67</sup> "inside information" must be "specific or precise". The use of "or" means that it is enough if the information is specific (even if it is imprecise) or if it is precise (even if it is unspecific). The old law used the word "specific" whilst the EC Directive<sup>68</sup> uses the word "precise". In the new provision a combination of the two alternatives is attempted. The connotation of "precise" is something exact and definite whereas the term "specific" seems to broaden the meaning *'to something pertaining to*



*something identified*'.<sup>69</sup> Thus, information that a company's profits were in excess of expectation would be "specific" (about the company) but not "precise" (in that the amount of the excess was not stated). In the Standing Committee, attention was drawn to the fact that the information can be either specific *or* precise.<sup>70</sup> Mr Nelson, Economic Secretary to the Treasury, gave as a typical example of specific information a bid that is going to be made.<sup>71</sup> He pointed out that 'precise' information would be the price at which that bid was going to be made. Precise information is "narrow, exact and definitive"<sup>72</sup> and, if it were used as the only prerequisite by the statute it would limit the scope of application of the new law. The addition of 'specific' information is in fuller conformity with the spirit of the Directive.

Alistair Alcock quotes one more interesting example given by the Minister:<sup>73</sup>

*'I hesitate to use examples, but, if it helps the Committee, I suggest that if somebody were to say during ... a lunch [between a company chairman and an analyst], "Our results will be much better than the market expects or knows," that would not be precise. The person would not have disclosed what the results of the company were to be. However, it would certainly be specific, because he would be saying something about the company's results and making it pretty obvious that the information had not been made public. In such circumstances it should not have been disclosed. It would be insider information because it would be specific.'*

While the intention of the United Kingdom draftsmen was to ensure that the information categorised as inside information was 'accurately expressed and distinctly formulated, the qualification that it should be "specific or precise" may provide more difficulty than assistance' according to one commentator.<sup>74</sup> The additional wording, however, will most probably assist juries in recognising that knowledge of a particular

forthcoming event is itself sufficient to constitute inside information without the need for the prosecution to establish that an individual knew some or all of the salient details connected with that event.<sup>75</sup> The criterion stipulated by the Directive [Art.1(1)] seems to be the only point of practical importance: The probable reaction of market traders on the release of the information is of importance and not the existence of the fact.<sup>76</sup>

The third<sup>77</sup> characteristic of the definition of inside information is that it must not have been made public. Section 58 is devoted to outlining the meaning of the phrase. The Act does not require that the information should be confidential to the company and this complements the extension of liability to individuals beyond those who hold information 'by virtue of being connected with the company' as in the previous law.<sup>78</sup> From the very beginning it is made clear that its "provisions are not exhaustive as to the meaning of that expression".<sup>79</sup> The courts are, therefore, given the power to extend the limits of what can be considered as made public, at the expense, perhaps, of certainty. Alcock has pointed out that the new guidance on the meaning of "made public", although well-received by the City, 'does not entirely compensate for the extra hazards created by the new Act no longer requiring inside information to be confidential'.<sup>80</sup> Accordingly the Stock Exchange requires all significant 'price-sensitive matters' to be confidential until properly announced through the Company Announcements Office ('Yellow Book' Section 5)<sup>81</sup> and the listing obligation to announce as soon as possible new developments that might be price sensitive will be extended to USM companies by statutory instrument.<sup>82</sup>

The Government was initially inclined to adopt the Directive's approach and leave the courts to interpret the phrase 'made public'. This met with vigorous opposition from several peers who felt that 'the



absence of a definition left an unwelcome degree of uncertainty surrounding the content of offences carrying up to seven years' imprisonment.'<sup>83</sup> The inclusion of a non-exhaustive definition of the meaning of "made public" in the statute 'is to be welcomed' and is undeniably better than the guideline approach which would create additional difficulties in a criminal statute failing to state with precision the content of an element of the offence.<sup>84</sup> This solution was dictated by the 'concern about the vulnerable position of analysts, particularly since the *Mackie* <sup>85</sup> case in Scotland'.<sup>86</sup>

The statute<sup>87</sup> deems information to have been made public if it is:

- (a) [...] published in accordance with the rules of a regulated market <sup>88</sup>for the purpose of informing investors and their professional advisers;*
- (b) [...] contained in records which by virtue of any enactment are open to inspection by the public;*
- (c) if it can be readily acquired by those likely to deal in any securities; or*
- (d) it is derived from information which has been made public.*

If one of these situations is present the information cannot be characterized as "insider information". If the information is published in accordance with the rules of a "regulated market"<sup>89</sup> for the purpose of informing investors and their professional advisers, irrespective of whether the market has already responded or not to the information<sup>90</sup>, it is considered as "made public". The same applies if the information is contained in public records, with no express limitation to public records of the UK, which by virtue of any enactment are open to inspection by the public. The provision states *inter alia* that information has been made public if it has been derived from information which has already been made public. Thus, for instance, the 'underlying logic' behind the published investment recommendation of a highly-respected financial

analyst would be considered as information within the public domain.<sup>91</sup> The wording, however, of section 58(3)(e) indicates that, in general, publication has to be in the UK since it makes clear that information *may* be treated as "made public" even though it is published only outside the UK.<sup>92</sup> The interaction between s. 58(2)(c) and s. 58(3)(e) was discussed at length in the Committee Stage and it was debated whether information published only in the 'Tonga Evening News'<sup>93</sup> could be treated as having been made public or the opposite conclusion would be justified for more parochial overseas publications. The Economic Secretary claimed that such issues are left to the courts but, nonetheless, admitted that a person divulging information could then deal immediately, 'even if the market had not had the time to adjust to the new information'<sup>94</sup> as under the legislation previously in force. It would appear, thus, that the employee who has had several hours' prior knowledge of the contents of an important company press release is legitimately able to '*beat the news*'<sup>95</sup> by trading before the market has had a chance to assimilate the full implications of the announcement. Finally, if the information can be "readily acquired by those likely to deal in any securities"<sup>96</sup> it qualifies as "made public". The last case should be interpreted narrowly. As Alcock remarks: 'a director is unlikely to be able to defend himself and any analyst he speaks to merely by saying that he would have been prepared to give the same information to any other analyst who rang him up'.<sup>97</sup> Likewise, it would be absurd to claim that the information was "readily available" to private shareholders or anyone who might deal.

In certain circumstances information *may* be treated as made public even though:<sup>98</sup>

(a) *it can be acquired only by persons exercising diligence or expertise;*

(b) *it is communicated to a section of the public and not to the public at large;*



*(c) it can be acquired only by observation;*

*(d) it is communicated only on payment of a fee; or*

*(e) it is published only outside the United Kingdom.*

The special provision on "expert assessments" under (a) consolidates the view that deductions made from public information are not "inside information". Indeed, if investment analysts, for instance, draw conclusions from information which is accessible to all who seek it in the right way, they will not be caught by the Act.<sup>99</sup> Thus, the assiduous investment analyst who systematically reads through recent issues of a relevant but obscure technical journal seeking information about a particular company may safely issue recommendations to his fund manager. The provision is intended to give analysts and fund managers a measure of assurance in circumstances where uncertainty as to the means of dissemination might discourage them from recommending transactions or dealing altogether. It is not, of course for the individual to show that the information he had fell within one of the recognised categories; the *onus* is always on the prosecution to prove that the information was not made public at the time.<sup>100</sup>

On the other hand, a person not certain if the information he has is public, under the new law had better assume that it is not.<sup>101</sup> Especially, if the information is available to a limited class of people, those who receive it must be on their guard.<sup>102</sup> Directors and many employees of quoted companies who are bound to have better specific knowledge of their company and of the relevant sector it operates in than 'can ever be obtained from public sources'<sup>103</sup> should exercise extreme caution about dealing not only in the securities of their own company, but also in the securities of other companies in the same sector.<sup>104</sup> In fact, as Norman Barry comments, researching out information, e.g. about rumours, and

passing that on to clients is now presumably illegal.<sup>105</sup> A guidance produced by the Stock Exchange<sup>106</sup> stresses that non-public price-sensitive information must always be given to the market as a whole, through the announcement mechanisms provided by the Exchange, and that such information must not be allowed "*to seep into the public domain.*" Directors and employees should also avoid discussing matters of the companies in the sector with analysts since this behaviour might amount to the crime of 'encouraging others to deal'.<sup>107</sup>

Information may be treated as made public if it has been communicated to a *section* of the public and not to the public at large. The absence of an adjective qualifying 'section' allows the court a considerable degree of latitude in cases where there has been only partial public disclosure of significant information.<sup>108</sup>

Equality of information in the stock markets could be paraphrased as '*the art of the possible*', and it is perhaps the latter that the law has made an attempt to master.

Fourthly, information must be "likely to have a significant effect on the price of any securities" if it were made public.<sup>109</sup> According to one interpretation the adjective "significant" means that the information must 'potentially have a major impact on the price'.<sup>110</sup> Movements in price of no importance are not sufficient for the purpose of the statute. The Take-over Panel for the purposes of requiring statements uses a 10 per cent 'untoward' movement on one day as a benchmark.<sup>111</sup>

The impact of eventual disclosure of inside information on the market price will depend in most cases on such variables as the liquidity of the company's shares and the prevailing market conditions.<sup>112</sup> Thus, the relatively vague test of "price-sensitivity" of information could not be substituted by a more specific universal standard for reasons of practicality



and it is left to courts to decide on individual cases.<sup>113</sup> The 1985 Act described price-sensitivity in relation to the probability that general disclosure of the information would have a 'material' effect on the market price of the affected securities.<sup>114</sup> The Directive refers to the probability of a 'significant' impact on price, and the same wording has been followed in section 56(2) of the 1993 Act.

The same section [s. 56(1)&(2)] comprises the definitions of two other related terms: "price-affected securities" and "price-sensitive information". For the purposes of this Part of the statute:<sup>115</sup>

*'securities are "price-affected securities" in relation to inside information, and inside information is "price-sensitive information" in relation to securities, if and only if the information would, if made public, be likely to have a significant effect on the price of securities.'*

Alastair Brown has rightly characterized this definition as "wonderfully tautologous".<sup>116</sup> Securities are price affected securities, and information is price sensitive information, if the information would, if made public, be likely to have a significant effect on the price of the securities. The 'materiality' will inevitably continue to be determined in most cases on the simple *post hoc* observation of the actual price shift recorded following proper disclosure of the information. Price-sensitivity, however, remains to be resolved under the 1993 Act according to the market conditions prevailing at the time of the alleged offence.<sup>117</sup> One more time the courts will have to decide what is a *criminal* passing on of price-sensitive information and what information could be freely communicated because it could not affect the price of securities.<sup>118</sup>

The individual who commits the offence must have information "as an insider"<sup>119</sup> and "from an inside source".<sup>120</sup> Thus, both an objective and a subjective element must be present.<sup>121</sup> An individual "has information

as an insider if and only if (making it, thus, perfectly clear that the definition is exhaustive<sup>122</sup>): (a) the information is, and the individual knows that it is, "inside information" and (b) he has it, and knows that he has it, from "an inside source".<sup>123</sup> Section 57(2) states that:

*"a person has information from an inside source if and only if:*

*(a) he has it through: (i) being a director, employee or shareholder of an issuer of securities; or (ii) having access to the information by virtue of his employment, office or profession; or*

*(b) the direct or indirect source of his information is a person within paragraph (a)"*

The definition of having information as an insider clearly requires the individual to know that he is an insider in the sense of realizing that he has the information by virtue of the relevant status, if he is a primary insider, or that the source of information is a primary insider (in the case of secondary insider). In the latter case he need not actually know the identity of that primary insider if he is aware of his status. In other words a person has information as an insider if he is an insider (i.e. has access to inside information either as a primary or as a secondary insider) and knows both that it is inside information and that he has it from an inside source.

The aim of the legislation, therefore, should not be to eliminate informational advantages, but to 'proscribe those advantages whose use would be improper, often because their acquisition was not the result of skill or effort but of the mere fact of holding a particular position.'<sup>124</sup> On the other hand the definition of information is largely a *compromise* between the need to protect investors and the need to avoid '*asphyxiating*' the market. If the concern for investor protection pushes insider dealing legislation too far, only *dealing in the dark* would be permitted. This would make it impossible for people to use the Stock Exchange.



### III. Securities

The prohibition will only apply in relation to certain investments which the statute terms "securities". The relevant securities are defined as:<sup>125</sup>

*'any security which (a) falls within any paragraph of Schedule 2; and (b) satisfies any condition applying to it under an order made by the Treasury for the purposes of this subsection.'*

The list of Schedule 2 comprises shares<sup>126</sup>, debt securities<sup>127</sup>, warrants<sup>128</sup>, depositary receipts in relation to shares<sup>129</sup>, options<sup>130</sup>, futures<sup>131</sup> and contracts for differences<sup>132</sup> in relation to any security falling within any category of "relevant securities" of Schedule 2. The latter can be amended by the Treasury by secondary legislation<sup>133</sup> giving, thus, the possibility to the legislator to extend the liability to new 'investment media and new abuses' as soon as they emerge.<sup>134</sup> A really important innovation of the new list is that it extends the liability of the old law by also covering Government or local authority stock. This extension of the definition of securities (along with the abolition of the connection requirement of primary insiders with the company<sup>135</sup>) has brought about a considerable increase in the scope of liability. The definition now includes gilts<sup>136</sup> and local authority stock, as well as futures and options.<sup>137</sup>

Alcock observes that although the definition of a company in the new Act (s. 60(3)(a)) is wide enough to cover unit trusts as well, the list of securities in Sched. 1 does not cover units in such trusts, apparently leaving unit trusts managers free to trade in the units of their trusts, but not managers companies operating investment trusts in their shares.<sup>138</sup> This solution is rather controversial because unit trusts are also related to securities traded on formal markets and raises questions as to the

protection of "small investors" who normally prefer them. The same commentator adds that at the request of LIFFE<sup>139</sup> the Schedule was specifically amended to cover derivative contracts in short term interest rates, even though they have no underlying security.<sup>140</sup>

According to section 54(1)(b) of the Act the Treasury will issue an Order stipulating conditions to be fulfilled by the investment which will qualify as a "security". The Insider Dealing (Securities and Regulated Markets) Order stipulates that in the United Kingdom these are any markets established under the rules of the London Stock Exchange, the London International Financial and Futures Exchange, the London Securities and Derivatives Exchange and Tradepoint.<sup>141</sup>

The main limitation imposed by the Treasury is that it restricts the legislation to market based securities:

*'The purpose of the legislation is to ensure confidence in the market in its broadest sense. So only transactions in securities that are market-related are to be caught. But because the terms on which securities are admitted to formal markets differ widely, and because the need to ensure that it is possible to apply the legislation to situations where there is a ready trade in securities related to those traded on formal markets, the section provides a power to describe the securities by order.'*<sup>142</sup>

According to Article 4 of the relevant statutory instrument 'The Insider Dealing (Securities and Regulated Markets) Order 1994 (SI No187) which came into force on 1 March 1994, the condition which applies to any security falling within any paragraph of Schedule 2 to the CJA above is that:

(a) it is officially listed in a State within the European Economic Area<sup>143</sup>; or

(b) it is admitted to dealing on, or has its price quoted on or under the rules of, a regulated market.<sup>144</sup>



In the Committee Stage debates, Anthony Nelson confirmed that the placing of new securities by stockbrokers as vendor consideration 'subject to listing' will not be caught by the new Act because, although the placees may agree to take the securities relying on a professional intermediary with information not yet made public, the securities are not yet listed. Alcock draws the conclusion that, if the previous argument is correct, the same must apply to underwritings and placings of all new issues, a point confirmed by the Earl of Caithness when the House of Lords considered the Commons Amendments.<sup>145</sup> This solution on the one hand restricts the problems that corporate finance activities have with the new Act to those involving securities that have already been issued, but, on the other, it means that all *'grey market dealings in new issues fall outside the ambit of the legislation'*.<sup>146</sup> .

#### IV. The Insider Dealing Offence

The activities covered by the Criminal Justice Act are basically the same as those covered by the Directive and the Insider Dealing Act 1985. The basic policy objectives of the new Act find expression in the new formulation of the offence which, in section 52(1), is as follows:

*"An individual who has information as an insider is guilty of insider dealing if, in the circumstances mentioned in subsection (3), he deals in securities that are price affected securities in relation to the information."*

The Act prohibits:

- (a) dealing as principal or as agent; [s.52(1)&(3), s. 55]
- (b) procuring another to deal as principal or as agent; [s. 55(1)(b)&(4)]
- (c) encouraging another person to deal who might reasonably be expected to do so [s. 52(2)(a)]; and
- (d) disclosing inside information other than in the proper

performance of one's duties [s. 52(2)(b)]

The secondary insider dealing is prohibited, but the exposition of the primary insider dealing offence will cover all that is necessary to explain the secondary offences.<sup>147</sup>

#### **i. Dealing or procuring dealing**

The main innovation is that for procuring or disclosing, the prosecution no longer needs to show that the insider knew or ought to have realised that someone would deal.<sup>148</sup>

The definition of dealing, as in the Insider Dealing Act 1985, includes merely agreeing to acquire or dispose of a security 'even if property never eventually passes'.<sup>149</sup> Dealing is further defined by s. 55 and includes acquisition and disposal as principal or agent or the direct or indirect procurement of an acquisition or disposal by any other person. In Attorney-General's Reference (No 1 of 1975),<sup>150</sup> '*procure*' was held to mean '*produce by endeavour*'. The defendant must therefore have caused the prohibited result by his actions. In that case the defendant charged with the procurement had added alcohol to the drink of another without his knowledge. It was held that if the defendant knew that the other man intended to drive and that the ordinary and natural result of the added alcohol was to cause him to have an alcohol concentration above the limit for drivers, the defendant had procured him to commit the drink/driving offence.<sup>151</sup>

The 'open-ended' definition of procuring in the Act caused some anxiety in the Committee stage<sup>152</sup>. As Dine remarks:<sup>153</sup>

*'The meaning of an 'indirect procurement' must therefore remain rather obscure, particularly so far as the mens rea to be proved. Must it be proved that the defendant foresaw or that it was reasonably foreseeable that the defendant's actions would*



*lead to another acquiring or disposing of securities? The relationship between this section and s. 52(2)(a) which prohibits the encouragement of another to deal is also somewhat obscure. Could there be an indirect procurement which was not an indirect encouragement to deal or vice versa?'*

Section 55(3) provides a non-exhaustive definition (subs (5)) of the circumstances in which an insider may be regarded as procuring an acquisition or disposal of securities by another. A person procures an acquisition or disposal of a security if the security is acquired or disposed of by a person who is:

- (a) his agent,*
  - (b) his nominee, or*
  - (c) a person who is acting at his direction,*
- in relation to the acquisition or disposal.*

This provision covers a number of permutations.<sup>154</sup> If a principal, for example, in possession of inside information gets an innocent agent, a professional dealer or simply a friend, to deal for him, the innocent agent (not having any inside information) is not liable being neither an insider nor a tippee. The principal, on the contrary, remains liable because he has procured the acquisition or disposal, despite not having dealt himself.<sup>155</sup> In *R v Goodman*<sup>156</sup> where the insider (a company chairman) gave his entire holding in the company to his girlfriend ahead of the news of significant losses and she disposed of the shares, he was treated as having procured their disposal. The same interpretation would apply in the case where the insider deals through a company which he controls. In this particular case the insider procures the dealing by another person acting at his direction. Consequently, the insider will be caught by this procuring element even if he chose not to deal in the price affected securities.<sup>157</sup>

To meet the very meaning of procuring the prosecution will have to

prove that the insider knew the other party would deal. Alcock adds convincingly that, in most cases, it is more than enough to prove the crime of encouraging, and that 'this tinkering with the onus of proof will not make a practical difference to many, if any, cases'.<sup>158</sup>

Dealing will only amount to an offence if it takes place in the circumstances set out in s. 52(3). They are:

(a) that the acquisition or disposal in question occurs on a regulated market; or

(b) that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary.

This wording follows Art 2(3) of the EC Directive which permits Member States to exempt deals not involving a professional intermediary. Previously, the off-market prohibition had only covered transactions in advertised securities which had been carried out by or through a party who had been authorised under the Financial Services Act 1986.<sup>159</sup>

According to the Act [s. 59(4)] reliance on a professional intermediary occurs if and only if:

"a person who is acting as a professional intermediary carries out an activity mentioned in subsection (2, mainly acquiring or disposing) in relation to that dealing."

*'Professional intermediary'* is defined in s. 59. Essentially, it is a person who holds himself out to a section of the public as being someone willing to engage in the acquisition or disposal of securities.

The transactions that fall within the scope of the Act are those effected on a 'regulated market' or when the person dealing relies on a professional intermediary or is himself acting as a professional intermediary [ss. 52(3), 59, and 60(1)]. Consequently, all European securities and derivatives markets are covered<sup>160</sup> as well as all other dealings by or



arranged through UK and overseas market-makers and securities brokers (e.g. Eurobond dealers).<sup>161</sup> Many corporate finance transactions of merchant banks and stockbrokers (but not, as Alcock observes, generally accountants or solicitors<sup>162</sup>), like underwritings, firm placings, rescue packages and the obtaining of irrevocable undertakings to accept take-over bids (s. 59), which are invariably based on material and unpublished information, have been covered by the '*closed circles*' defence in an effort to remove the prospect of prosecution from the conduct of legitimate corporate finance deals.<sup>163</sup> The definition given to 'professional intermediaries' alone is probably wide enough to catch lawyers and accountants instructing securities transactions on behalf of their clients but section 59(3) removes the application of the dealing offence from those who '*incidentally*' or '*occasionally*' act as professional intermediaries. The EC Directive [Art. 2(3)] permits Member States to cover all off-market transactions including private face to face deals. The UK government, unlike some of its continental counterparts chose not to do so.<sup>164</sup> Thus, cases where company's securities are not traded on the market do not fall within the scope of the legislation. If among the objectives of the insider dealing legislation ranks the prevention of the improper use of information possessed by insiders, it is easy to see that cases of abuse of inside information are equally likely to arise in shares of non-quoted companies.<sup>165</sup> Professor Murray remarks that a case where directors bought in knowledge of an impending take-over (*Percival v. Wright* [1902] 2 Ch 421)<sup>166</sup>, often invoked as the classic case of what constitutes insider dealing, occurred in an unquoted English company.<sup>167</sup> The partiality of law, which criminalizes the reprehensible behaviour in one case and not in the other, can hardly be justified.<sup>168</sup>

The *mens rea* of the dealing offence requires the prosecution to prove

that the individual knew both that his information was inside information and that he has it from an inside source.<sup>169</sup> It must be shown, therefore, that the defendant understood the specificity and materiality of the information at the time he chose to deal and the same 'subjective appreciation'<sup>170</sup> has to be shown in relation to the source of the information: either that the defendant knew he had the information on account of his inside position or, in the case of a tippee, that he had the information directly or indirectly from the one who was in that position. The fact that the individual did not at the time of the transaction expect the dealing to result in a profit attributable to the price-sensitive nature of information or that he would have acted the same way if he had not had the information may constitute a defence.<sup>171</sup>

The Act (s. 62) follows Art. 5 of the Directive in defining the territorial scope of the crime of insider dealing. Crimes of dealing or procuring are committed if either the perpetrator, the market or the professional intermediary used is in the UK. For this purpose, there are three UK markets, the Stock Exchange, LIFFE and OM<sup>172</sup> London (Art. 9 Draft Order).<sup>173</sup> The 1993 Act has apparently adopted the *lex loci delicti* approach dictated by the Directive. It also follows the Directive regarding a transaction as carried out within its territory if it is carried out on a market which 'by an order made by the Treasury, is identified (whether by reference or by criteria prescribed by the order) as being .... regulated in the United Kingdom' s.62(1)(b).

The Directive requires that the Member States prohibit insider dealing in transferable securities "admitted to a market of a Member State"<sup>174</sup> and not just those admitted to its own markets. In line with this requirement, the 1994 Order extends the application of the Act to securities which are officially listed in or are admitted to dealing under the



rules of any investment exchange established within any of the states of the European Economic Area. This solution of 'applying domestic sanctions irrespective of a foreign element' has been rather wrongly criticised as creating criminal law with an unacceptable territorial reach.<sup>175</sup>

## ii. Disclosing

Section 52(2)(b) provides that an individual who has information as an insider is guilty of insider dealing if: 'he discloses the information, otherwise than in the proper performance of the functions of his employment, office or profession, to another person.' Consequently, individuals passing on inside information in proper discharge of their duties are not within the scope of the provision. The simple disclosure of information is the most likely offence to be limited by the concept of 'taking advantage' discussed below.<sup>176</sup>

In all three types of insider dealing the requisite *mens rea* of the offence is knowledge both that the information is "inside information" and that the defendant is an "insider" in the sense of either knowing that he has the information by reason of the relevant status (primary insider) or knowing that the source of the information is a primary insider.<sup>177</sup> The prosecution has to establish, in other words that the individual knowingly understood the quality and source of the information at the time of the disclosure. It is no longer necessary to show that the individual must have intended to bring about a particular result as a consequence of his disclosure. It does not have to be proved, for instance, that the defendant intended or ought to have realised that the recipient would use the information to advise others to deal in the affected securities.<sup>178</sup> On the other hand, the defendant now has a defence that he did not expect anyone to deal because of the disclosure. The *onus* of proof, however, is on him (s.53(3)).<sup>179</sup>

The crime of disclosing information is committed if either the tipper or tippee is in the UK at the time of the disclosure (s.62(2)). The *lex loci delicti* approach of the Directive has been implemented in a narrower fashion to the disclosing offence.

### iii. Encouraging others to deal

The third way of committing the offence is by encouraging others to deal [s. 52(2)(a)]. It must be shown that the deal occurs in a regulated market or is effected through a professional intermediary. It would seem that this must be the case as the offence is complete on proof of encouragement. It has been correctly remarked that the essential *actus reus* of the offence under section 52(2)(a) is the imparting of advice to deal in the specified securities as opposed to substantive disclosure of the information which led the individual to give that advice.<sup>180</sup> The actual deal need not have taken place. A specific encouragement to deal on the market or through professionals must therefore be shown. It is irrelevant whether the advice was offered gratuitously or for personal gain.<sup>181</sup> Palmer observes that any dealing which ensues need not be on a "regulated market" or be by or in reliance on a "professional intermediary", although, the defendant must "know or have reasonable cause to believe" that the dealing will take place.<sup>182</sup> It does not matter, therefore, if it later transpires that it occurs in some other way. If the person encouraged does receive the "inside information" the disclosing offence has also been committed.<sup>183</sup>

The *mens rea* of this type of the offence has some additional elements. The offender must know or at least have reasonable cause to believe that the dealing will take place either on a "regulated market" or by or in reliance on a "professional intermediary". The minimum set by the provision is that the defendant must have "reasonable cause" to



believe that the dealing will take place in the relevant circumstances, has been characterized as an 'objective element' introduced into the *mens rea*. The defendant can be convicted without the recipient of the advice having known that the former had the benefit of price-sensitive information when he was encouraged to deal. It is not even necessary to prove that the recipient actually heeded the advice given by buying or selling the relevant securities.<sup>184</sup>

The crime of encouraging others to deal is committed if either the person who encouraged or the recipient of the encouragement is in the UK at the time of the encouragement of the dealing (s.62(2)).

### **Taking Advantage**

According to the Directive [Article 2(1)] the person in possession of inside information is to be prohibited from "taking advantage of that information with full knowledge of the facts by acquiring or disposing of, for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which that information relates". The prohibition of "taking advantage" is extended by Art. 4 to secondary insiders who with full knowledge of the facts possess inside information. It must be shown that the defendant was "taking advantage" of inside information.<sup>185</sup> If the factors discussed so far can be proved, the defendant is presumed to have "taken advantage" of the information in dealing, disclosing or encouraging others to deal but the presumption of taking advantage can be displaced by proof by the defendant (presumably on balance of probabilities) of a number of available defences.<sup>186</sup>

One interesting aspect of the insider dealing prohibition is the *scienter* requirement which reflects the wording of the Directive. Insiders must take advantage of the information "*with full knowledge of the facts*"

according to the Directive and the Act provides [s. 57(1&2)] that a person has information as an insider if and only if: (a) it is, and he knows that it is, inside information, and (b) he has it, and knows that he has it, from an inside source. The inference is necessarily drawn that the insider must have acted wilfully. As Rider points out "mere carelessness while in possession of inside information will not be enough".<sup>187</sup>

## V. Defences

The wider scope of the basic crimes in the new Act, has enhanced the importance of defences. The Act comprises various defences to insider dealing. Two groups of defences can be distinguished: Defences of a general nature [s. 53] and defences of a specific nature or special defences contained in Schedule 1. It should be noted, at this point, that the Treasury is empowered by the Act [s. 53(5)] to amend Schedule 1 by order. The general defences of s. 53 are not amendable whereas the specific defences of Schedule 1 could be improved, extended or abolished.

### a) general

In section 53 there is special provision for each of the three types of insider dealing. According to the Act an individual is not guilty of insider dealing "*if he shows*" that certain conditions are fulfilled. Thus, the defendant has to prove that the circumstances stipulated by s. 53 exist. The defences applicable to "dealing" and "encouraging" are almost identical:

(a) If the defendant shows that he did not expect the dealing to result in a profit attributable to the fact that the information was "price-sensitive information in relation to the securities", he is not guilty of insider dealing. It is made clear by the provision that "the avoidance of a loss" is included in the meaning of "profit" [s. 53(6)]. The defendant is afforded a defence if it is proved that he did not anticipate, based on his subjective



judgement, that the transaction would result in a profit (or in the avoidance of a loss). A similar defence existed under the previous legislation.<sup>188</sup> The new Act<sup>189</sup> does not extend this defence to trustees or personal representatives who have information but act on the advice of a professional manager of the assets.<sup>190</sup> These cases could now rely on the third general defence that the accused 'would have done what he did even if he had not had the information' [s. 53(1)(c), 2(c)].

(b) The second general defence to dealing and encouraging (but not to disclosing) can be invoked when the defendant 'believed on reasonable grounds that the information had been or would be disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having the information'.<sup>191</sup> In this particular case the criterion is an objectively reasonable belief that the information is sufficiently widely known.<sup>192</sup> If this defence were available when the *Mackie*<sup>193</sup> case was tried it might have led to the adoption of a different line of argumentation. It could be invoked by an 'honest investment analyst'<sup>194</sup>, even if the information on which he relied had not been "made public", provided he can 'point to the basis on which he believed there had been wide disclosure'.<sup>195</sup> Corporate finance transactions like underwriting secondary issues or obtaining irrevocable acceptances for bids depend on this defence.<sup>196</sup> An employee of an institution, for example, might commit his employer to underwrite an offer subject to approval by the employer's board and 'the board might approve the deal on the basis of the employee's recommendation without knowing much of the contents of the offer document'.<sup>197</sup>

(c) The defendant has a defence if he shows that he would have dealt or encouraged another to deal "even if he had not had the information" [s.53(1)(c), (2)(c) and (6)]. In other words, the defendant must prove that the

event of being in possession of the information was *'fortuitous'* in the sense of not causing him to deal (or encouraging another to deal).<sup>198</sup> It has already been noted that this defence would give protection to a trustee or personal representative who has inside information, but is acting on the advice of a professional manager of the assets, or it would protect an analyst who has been given inside information but tries to continue to advise his clients on the basis of the information he had before.<sup>199</sup> According to Alcock this defence should also cover *bona fide* activities of liquidators, receivers and trustees-in-bankruptcy who no longer have a specific defence.<sup>200</sup> On the other hand, the same commentator sounds a cautionary note: "this defence does highlight to the unscrupulous, the potential for '*manufacturing*' evidence after the event to show that the accused always intended to act in the way he did before he obtained the inside information."<sup>201</sup> The insider dealing enforcement records<sup>202</sup> rather lend probability to this theory.

Individuals prosecuted for the "disclosing" offence are afforded two different defences:

(a) Firstly, if the defendant can show that he did not expect at that time (*i.e.* at the time of the disclosure) that any person would deal, because of the disclosure, either on a "regulated market"<sup>203</sup> or as or in reliance on a "professional intermediary"<sup>204</sup>. Here the test is again subjective. If the defendant can prove that he did not anticipate that anyone would deal on the basis of the disclosure, as it has been succinctly put, 'no matter how naive the expectation that the recipient would not deal on the basis of the disclosure was'.<sup>205</sup> The defence could still arise if the defendant did not expect the recipient of the information to deal on a regulated market, or that the person dealing would rely on a professional intermediary or would himself act as a professional intermediary.<sup>206</sup>



(b) In addition, if the defendant can show that "although he had such an expectation at that time"<sup>207</sup>, he did not expect the dealing to result in a profit attributable to the fact that the information was price-sensitive information in relation to the securities.<sup>208</sup> This defence is quite similar to the first defence considered above in relation to the "dealing" and "encouraging" offences, and its test is similarly subjective. It should be stressed that in all cases the *onus* of proof is upon the accused and that 'the standard of proof would be a balance of probabilities, as usual where there is an evidential burden on the accused'.<sup>209</sup> The jury will, eventually, take a view on the motive behind the dealing.

#### **b) special**

Schedule 1 provides for three specific defences.<sup>210</sup> They are applicable to the cases of "dealing" and "encouraging". As presently worded, Schedule 1 is irrelevant if the offence amounts to mere disclosure of information. The Schedule, as has already been noted, may be amended by Order. The defendant must prove that the terms of the defence are fulfilled.

The first special defence applies to "market makers". According to the definition of Schedule 1<sup>211</sup>, a market maker is a person who:

*(a) holds himself out at all normal times in compliance with the rules of a regulated market<sup>212</sup> or an approved organisation<sup>213</sup> as willing to acquire or dispose of securities; and*

*(b) is recognised as doing so under those rules.*

Market makers who can show that they acted in good faith in the course of their business as market makers or their employment in the business of a market maker, are not guilty of insider dealing by virtue of dealing in securities or encouraging another person to deal. This is

probably derived from the preamble to the Directive where it is noted that the mere fact that market makers who have inside information confine themselves to pursuing their normal business of buying or selling securities, should not in itself be deemed to constitute use of such inside information. The aim of the defence is to facilitate the conduct of ordinary business of market makers who have a particular stock in their book and who acquire information which they did not seek.<sup>214</sup> The meaning of "good faith" is not specified by the provision but it could reasonably be interpreted as comprising actions within the scope of market making business and in accordance to normal market practices.<sup>215</sup> An individual market maker is clearly not acting *bona fide* as a market maker if he takes a personal profit from inside information but it is uncertain whether a market maker, who having learned of an unannounced take-over bid, aggressively purchases the target's shares for the firm's own 'back book' and in the process improves his personal bonus,<sup>216</sup> is acting in bad faith. This defence is similar to the "jobber"<sup>217</sup> and "market makers"<sup>218</sup> exemption of the Insider Dealing Act 1985 and remains as controversial as its predecessors.

The second "special defence" relates to market information. Market information is defined as information consisting of one or more of the following facts:<sup>219</sup>

- (a) that securities of a particular kind have been or are to be acquired or disposed of, or that their acquisition or disposal is under consideration or the subject of negotiation;*
- (b) that securities of a particular kind have not been or are not to be acquired or disposed of;*
- (c) the number of securities acquired or disposed of or to be acquired or disposed of or whose acquisition or disposal is under consideration or the subject of negotiation;*



*(d) the price (or range of prices) at which securities have been or are to be acquired or disposed of or the price (or range of prices) at which securities whose acquisition or disposal is under consideration or the subject of negotiation may be acquired or disposed of;*

*(e) the identity of the persons involved or likely to be involved in any capacity in an acquisition or disposal.*

In essence, it is information which market participants may acquire in the course of that participation. Apart from the acquisition or disposal of securities that have taken place or will do so, market information includes the possibility that the transactions are under consideration or that someone is not dealing in securities of a particular kind. It also comprises the possibility that someone might know the range of prices at which dealing is contemplated as well as the price at which particular transactions are to take place.<sup>220</sup> The "market information" defences break down into two categories. The first applies when the defendant can show both that the information was "market information" and that it was "reasonable" for an individual in his position to have acted as he did despite having that information as an insider at that time.<sup>221</sup> The test of what is reasonable will be connected with the content of the information, the circumstances and the capacity in which he first had the information, and the capacity in which he now acts. This would probably cover the case of a person who acquired market information when he was not "an insider" but later became an insider.

The second market information defence<sup>222</sup> can be invoked by persons who deal or encourage others to deal in the context of facilitating dealing which was already under consideration (as for example when building up a stake in a company prior to a take-over). Accordingly the directors of a 'predator company having the inside information that their company was

about to take over another, may themselves buy shares in the target company or encourage others to do so in order to facilitate the take-over'<sup>223</sup> and the same applies to banks if they underwrite or place securities without giving progress reports. In the previous law<sup>224</sup> this defence was extended to the "disclosing" offence but its scope has now been considerably curtailed by the new Act. The case of "*front running*" or in other words, dealing for a private gain ahead of the publication of an highly regarded analyst's report in which the analyst is dramatically changing his views on the company and which will inevitably affect the price of the securities will not be covered by the defence.<sup>225</sup>

The new Act retains<sup>226</sup> the defence for stabilising new issues, providing such stabilisation complies with the SIB rules on the subject (Sched.1, par. 5). The SIB is empowered to make rules as to stabilisation of certain securities. The issuer may be permitted to deal in the securities in order to maintain the market price as long as he complies with the rules, during the period specified by the SIB. Otherwise the issuer could be found guilty of "insider dealing" for having the "inside information" that the stabilising process was in progress. According to one commentator activities in furtherance of legal stabilisation will also fall within the scope of the defence.<sup>227</sup>

Both the general and the special defences set out in the Act place the onus on the accused to bring himself within them. The prosecutor does not have to displace them, at first instance, though, in appropriate cases he will 'wish to have and lead evidence designed to counter any attempt to invoke them'.<sup>228</sup>



## VI. Sanctions

### a) Criminal Liability

The Directive in Article 13 leaves to Member States the penalties for Insider Dealing and merely provides that the penalties "shall be sufficient" to promote compliance with the measures taken pursuant to it. A Member State is, accordingly, free to impose criminal or civil sanctions for insider dealing or a combination of both.

According to the provisions of the Act:<sup>229</sup>

*An individual guilty of insider dealing shall be liable:*

*(a) on summary conviction, to a fine not exceeding the statutory maximum or imprisonment for a term not exceeding six months or to both; or*

*(b) on conviction on indictment, to a fine or imprisonment for a term not exceeding seven years or to both.*

The Act, in other words, has carried on the tradition of criminal sanctions, first introduced in 1980, by placing exclusive reliance upon criminal sanctions. The solution of exclusively criminal law sanctions for the offence of Insider Dealing has been questioned both for its deterrent effect and its enforcement potential. Before the promulgation of the Act, one commentator stated that 'the most urgent reform must be to improve the detection and prosecution of rule-breakers'.<sup>230</sup> The '*sorry record of enforcement*' which has been characterised as the biggest failing of the British system, is, to a considerable extent, due rather to the procedural system than to drafting errors of the legislation. The '*inherent vice*' of the enforcement procedure of the legislation could be put down to three different elements.

*Firstly*, the offence displays such a complexity that the prosecution case is likely to come to grief for technical evidential reasons.<sup>231</sup> Moreover,

the likelihood of successful prosecutions is jeopardised by the fact that the provisions are construed according to rules of evidence and, principally, the presumption of innocence, that were developed originally, as Brown points out, 'for the protection of persons accused of offences which at one time carried the death penalty'.<sup>232</sup> Secondly, an additional obstacle is posed by the lack of efficiency of the jury system. The complexity of the issue and its context which has little to do with the daily experience of the jury create some doubts as to whether juries are 'a fit means of trying cases of this sort'.<sup>233</sup> Proper research on the competence of the juries can not be carried out without the repeal of section 8 of the Contempt of Court Act 1981, which was proposed by the Runciman Commission (1993). Finally, Brown points to the nature of the offence, which in his view is *clandestine*, and 'it is usually carried out by someone who is blessed with greater than average intelligence and has applied that intelligence to concealing his actions'.<sup>234</sup> This remark should not lead to the inference either that this characteristic pertains only to the offence of insider dealing or that prosecution is rendered impossible because of the capabilities of the potential offenders. Above all, it has no significance regarding the criminal character of the act.

Critics examining the primary reason for poor enforcement of British Insider Trading statutes, point to the fact that only criminal sanctions are available.<sup>235</sup> The prosecutor has to prove the allegations *beyond reasonable doubt*, in order to achieve a criminal conviction, and many times it can be extraordinarily difficult because of the nature of the crime to demonstrate the link between the trader and the information to that degree. The view has been expressed by many that civil actions can increase the deterrent effect of the law and, at the same time, provide compensation for victims of the activity, especially in circumstances



where the criminal penalties do not have a sufficient deterrent. Such circumstances can occur where the detection is difficult and where an economic calculation is conducive to wrong-doing.<sup>236</sup> Civil sanctions, on the other hand, require a far less burdensome standard of proof based on a balance of probabilities in comparison with Criminal provisions that require proof beyond reasonable doubt.

A critique<sup>237</sup> of the new British Insider Dealing Legislation attributes the superior rate of convictions of the French *Commission des Opérations de Bourse* (COB) and the American *Securities and Exchange Commission* (SEC) to the fact that neither the COB nor the SEC has to resort to criminal law. They both rely first on civil law, though the guilty may be charged with criminal offences as well. The commentator remarks that:<sup>238</sup>

*"Besides forcing wrongdoers to give back their ill-gotten gains, both the COB and the SEC can fine convicted insiders a multiple of those profits - up to three times the gains from transactions in America (though the SEC normally settles for less), and up to ten times in France.*

*Easier convictions make fines more of a deterrent. In Britain, insiders face unlimited fines and up to seven years in jail. But that is not much of a deterrent when so few are convicted. In the unlikely event that any one in Japan is convicted of insider-trading, he will face a maximum fine of ¥500,000 (\$5,100) and six months in jail."*

For criminal cases, trials should be shortened and simplified. It has been suggested that the Serious Fraud Office should 'trim'<sup>239</sup> the number of charges it brings and assemble its cases more quickly. In addition, increasing the number of high-court judges would help. One more proposal supports a fuller use of preparatory hearings, for which the defence should be required to disclose its case in advance. Perhaps any changes that increase the chances of punishment for wrongdoing would contribute more to the improvement of the regulation of Insider Dealing

than 'any amount of tinkering with regulatory structures'.<sup>240</sup>

It should be noted at this point that both the SEC and the COB have specialist departments with lawyers who handle most investigations and civil suits themselves. The COB has 50 people in its enforcement division, all of whom can investigate insider-trading; the SEC has over 800. Britain has no special insider-trading unit, apart from a team of about 20 at the London Stock Exchange.<sup>241</sup> The findings of the Exchange are passed to the DTI, which, if it considers there is a strong enough case, appoints a 'couple of *ad hoc* inspectors to look into it.'<sup>242</sup> The problem of "staffing" of specialist departments with insider-trading investigators is even worse in other EC Member States and may hinder the enforcement of the Insider Dealing Directive.<sup>243</sup>

Another difficulty in prosecuting insiders has arisen from *Saunders v. United Kingdom*,<sup>244</sup> The European Court of Justice upheld a Commission's Report which adopted the view that Article 6(1) of the European Convention on Human Rights had been violated by the conviction of Saunders, Guinness chairman during the notorious Distillers' takeover bid who complained that the use of his criminal trial of transcripts of interviews with the DTI inspectors violated Article 6. Saunders relied upon the fact that he was under a duty to answer the inspector's questions, enforceable by proceedings for contempt. The Commission concluded that:

*"the use at the applicant's trial of incriminating evidence obtained from him under compulsory powers was oppressive and substantially impaired his ability to defend himself against the criminal charges facing him. He was therefore deprived of a fair hearing within the meaning of Article 6."*

In the Commission's opinion, the privilege against self-incrimination is an important element in safeguarding an accused from



oppression and coercion during criminal proceedings. The Government's argument that protection against self incrimination is not justified for people enjoying a fiduciary position towards the public did not convince the Court.

The impact of the Saunders case on insider dealing proceedings remains to be seen. It can be reasonably inferred that it will not make things easier for the supervisory or enforcement authorities.

In addition to the traditional criminal penalties which may be visited upon insiders, it seems that the disqualification sanction is available against some insiders. The effect of disqualification is to disable the person disqualified from being involved in the running of companies in the future.<sup>245</sup> In *R. v. Goodman*<sup>246</sup> the Court of Appeal took a liberal view of what could be said to be "in connection with the management of the company", so as to bring within the phrase the managing director's disposal of his shares in the company advance of publication of bad news about its prospects and upheld the Crown Court's decision to disqualify, for a period of 10 years, a managing director convicted of insider dealing. The Crown Court had invoked section 2 of the Company Directors Disqualification Act 1986 which enables a court to disqualify a person who has been convicted of an indictable offence in connection with the management of a company.

### **b) Civil Consequences**

It has already been suggested that treating insider dealing as a matter of civil liability could be dealt with in a lower standard of proof than the standard required in a criminal case. UK courts have not offered any realistic civil sanctions against insider dealing and the relevant case law indicates that courts are reluctant to imply that directors and other agents

of a company owe 'anything other than duties created by contract to shareholders'.<sup>247</sup> Insiders owe no duty to reveal the basis upon which they are dealing, whether it is direct with an investor or through a market-maker, since normal contractual terms are *caveat emptor*.

Insider dealing has been often, wrongly characterised as a "victimless crime".<sup>248</sup> The main counter-arguments against this theory are on the one hand the fact that the illegal use of inside information presupposes that some improper advantage will have been taken over some other party, and, on the other, that the company where the insiders practice insider dealing may be a victim.<sup>249</sup> Indeed, the company may suffer financial loss and, more importantly, its reputation may be irreparably damaged by the acts of insiders. What seems to be the real hindrance for civil actions is the lack of adequate title to pursue a claim.<sup>250</sup>

It should not be inferred from the previous paragraph that insiders are free from any liability for dealing on inside information. Directors, employees, agents in general, auditors or financial advisers of the company, who have used information confidential to the company can, in theory, be asked to account for any profit made thereby even if the company itself has suffered no loss, but, in practice this rarely happens.<sup>251</sup> Insiders could even be liable for profits made by others to whom the confidential information was divulged and those could also be liable if they knew or should have known that the information they were using was obtained through a breach of fiduciary duty by an insider.<sup>252</sup>

Actions based on breach of fiduciary duties to the company can be brought even if no offence was committed under the Act or if the company did not suffer any loss. Individuals bound by such duties will be liable to the company to make over any profits arising out of the use of such information. The practical difficulty entailed is that only the board of



directors of the company can authorise the company to institute proceedings against a fellow director who owes such duties to the company and who has acted in breach of his duties. As Professor Murray has observed: 'It is much more likely that a director will be found to have retired or resigned for "personal reasons" or to devote his attention to his other interests or whatever, leaving the matter in limbo, than that public proceedings will be taken against him.'<sup>253</sup>

Another difficulty is related to circumstances when a minority shareholder might be able to claim that with an effective theft from the company of its property, there has been a fraud on the minority, such shareholder actions are "highly unlikely after the *Prudential v Newman*<sup>254</sup> fiasco".<sup>255</sup>

Insider dealing may lack credible plaintiffs<sup>256</sup> in most cases but when the board of a company changes, as could happen after a take-over, the new board, as phrased by Professor Murray<sup>257</sup>, 'may be quite ruthless about recovering as much as possible from the former directors in matters of this sort'. In the *Diamond v. Oreamuno*<sup>258</sup> (1969, New York Court of Appeals) case directors of a company, in breach of their fiduciary duties, sold their shares on the market at a favourable price, knowing that because of an increase in expenses profits had fallen drastically, before that information was made public. Subsequently, when the shares dropped, they were held liable to the company for the difference, although the company was not the party who had suffered that particular loss. In the opinion of Fuld C.J: "It is true that the complaint before us does not contain any allegation of damages to the corporation but this *has never been considered to be an essential for a cause of action founded on a breach of fiduciary duty*. This is because the function of such an action, unlike an ordinary tort or contract case, is not merely to compensate the plaintiff for wrongs committed by

the defendant but, as this court declared many years ago 'to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates."

In relation to the potential harm to the company the same judge conceded: "In addition, it is pertinent to observe that, despite the lack of any specific allegation of damage, it may well be inferred that the defendant's actions might have caused some harm to the enterprise. Although the corporation may have little concern with the day-to-day transactions in shares, it has a great interest in maintaining *a reputation of integrity, an image of probity*, for its management and in ensuring the continued *public acceptance and marketability of its stock*. When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities [emphasis added]." Consequently, it could be safely inferred the actions of directors *might* cause damage to the enterprise but the breach of fiduciary duty is the basis for awarding damages, regardless of the proof of actual loss.

In exceptional circumstances civil remedies may be provided by sections 61 or 62 of the Financial Services Act 1986 where clients of a person authorised according to the Act suffer loss by reason of the breach of the rules by the authorised person. These can only apply in very limited circumstances, namely, only if the party to the transaction who committed the insider dealing offence is an authorised party, in conformity with the provisions of the Act. In addition, such persons will have to prove actual loss. The scope of these remedies is therefore limited, and, moreover, they are '*untried*' in the context of insider dealing.<sup>259</sup>



The reluctance of British law to afford civil remedies, in the absence of breach of fiduciary duties, to individuals who have suffered loss resulting from insider dealing is reflected by the case of *Percival v Wright*<sup>260</sup>, 'often referred to as the classic case of what constitutes insider dealing'.<sup>261</sup> The plaintiff, a shareholder who sold his shares to the chairman and two other directors of a company, sought to have the sale transaction set aside on the ground that the directors were in possession of information (on an impending take-over) which they ought to have disclosed when negotiating for the purchase of the shares. The court ruled that a director purchasing shares need not disclose a large casual profit, the prospect of a good dividend or the discovery of a new mine, and, likewise a director selling shares need not disclose losses incidental to the ordinary course of management. The argument of the plaintiff was based on a fiduciary duty that directors owed to all other shareholders at the point of an impending take-over which would oblige them to make such information available. The court found that no such duty was owed to the members of the company and the action of the plaintiff failed on that ground nor does English law afford any remedy for persons like the plaintiff.

The practical effect of this decision, so far as shareholders or third parties (injured and without a breach of fiduciary duty owed to them) are concerned, is that directors have no duty to reveal inside information or to abstain from using it, the breach of which could give rise to civil claims against them.

Making people civilly liable for insider dealing would form a manner of giving redress for insider dealing without the costly and burdensome procedures of criminal trials. The prospect of being found liable to parties who have lost because of the transactions should have a deterrent effect to

persons who would otherwise indulge in insider dealing. The argument that might be advanced that the objective of insider dealing regulation is to maintain the integrity of the market, and, therefore, civil sanctions would be inappropriate, does not seem convincing.<sup>262</sup>

An example of a civil penalty is provided by the Insider Trading Sanctions Act 1984 of the United States. It authorises a court in an action by the Securities and Exchange Commission to impose a civil penalty of up to three times the insider's profits. In addition, the party adversely affected may rescind the contract. Civil remedies are also provided for by the Irish legislation (Companies Act 1990, s. 109) which implemented the Insider Dealing Directive of the EC.<sup>263</sup>

The measure of profit (or loss avoided) could be, according to one approach, the difference between the price at which the insider or tippee traded and the market price of the security a reasonable time after the material information becomes available publicly.<sup>264</sup> It could be at the discretion of the regulatory agency to distribute the amount so recovered to those who traded contemporaneously with the insider or tippee. Civil remedies which concentrate on compensation have to confront the problem of 'demonstrating harm to any individual trading on an exchange'.<sup>265</sup> Professor Cranston adds in relation to civil remedies and the measure of damages:<sup>266</sup>

*"It can be argued that if the individual trades on the basis of his own evaluation, he is not induced to do so by the insider's trading, and any loss suffered is not caused by the latter. But against this can be said that if an insider or tippee had a duty of disclosure at the time of his trading, the failure to do so would cause loss, because if there had been disclosure at the time of his trading, the individual would not have traded. As the Anisman report (Insider Trading Legislation for Australia) argues, there is no rational basis for distinguishing between an individual who just happens*



*to trade with an insider and one who does not, although there will be a need to provide a limit on what could be substantial potential damages. Consequently, it would not be right to confine the cause of action to investors who are direct parties to a transaction with an insider. (Those dealing directly with an insider, however, should be able to obtain full compensation, without being subject to the limit mentioned.) A tipper should also be liable, for his and his tippee's activities. Again there is a need to provide a limit on potential damages.*

*As regards the measure of damages, the courts should have a discretion. However, the Anisman Report suggests a prima facie rule for transactions on a stock exchange, whereby damages would be measured in terms of the difference between the price paid or obtained and the market of the security a reasonable time after the material information became generally available. There would need to be defences if, for example, a major economic event caused the prices of the security to move."*

The previous legislation<sup>267</sup> provided that no transaction was "void or voidable" by reason only of contravention of the insider dealing prohibition. The new Act has changed the word "voidable" to "unenforceable"<sup>268</sup>, thus, ruling out the possibility that arose in the decision of *Chase Manhattan Equities Ltd v Goodman*<sup>269</sup>. In the latter case a sale agreement in contravention to s. 1 of the Company Securities (Insider Dealing) Act 1985 was found "*tainted by illegality*" and therefore "unenforceable". The solution of the Criminal Justice Act 1993 is dictated by the need to avoid upsetting the market and to maintain a level of certainty in transactions. It seems justified on the basis of financial market policy considerations but could possibly have some unfair results on victims of insider dealing. The possibility of prejudicing the rights of persons who have suffered loss as a result of the acts of insiders could be eliminated by affording civil remedies to these individuals.

## VII. Territorial Scope and Co-operation between Member States

By Art. 5 of the Directive, the Member states are to apply the prohibitions 'at least' to actions undertaken within its territory 'to the extent that the transferable securities concerned are admitted to trading on a market of a Member State'. This provision appears to be of impenetrable obscurity but an attempt has been made to reflect the Directive in s. 62 which restricts jurisdiction to acts done within the United Kingdom or markets declared by Treasury order to be a market regulated in the United Kingdom. It is not necessary that the dealing should have occurred within the United Kingdom: 'any act forming part of the alleged dealing' will be sufficient to found jurisdiction. According to the Act:<sup>270</sup>

*"An individual is not guilty of an offence falling within subsection (1) of section 52 unless:*

*(a) he was within the United Kingdom at the time when he is alleged to have done any act constituting or forming part of the alleged dealing;*

*(b) the regulated market on which the dealing is alleged to have occurred is one which, by an order made by the Treasury, is identified (whether name or by reference to criteria prescribed by the order) as being, for the purposes of this Part, regulated in the United Kingdom; or*

*(c) the professional intermediary was within the United Kingdom at the time when he is alleged to have done anything by means of which the offence is alleged to have been committed."*

For the case of disclosing the Act specifies<sup>271</sup> that either the person who discloses or encourages must have been in the United Kingdom at the time when he alleged to have disclosed the information or encouraged the dealing or the alleged recipient of the information or encouragement was within the United Kingdom at the time when he is alleged to have received the information or encouragement.



Financial crime in general is largely a cross-border phenomenon. Increasing internationalisation of securities markets has made more difficult the task of investigating securities law abuses. In the past, governments were rather reluctant to co-operate in law enforcement matters. That reluctance which created serious problems of enforcement, has, in recent years given way to an 'eagerness for improved arrangements and that eagerness has spawned several important treaties and informal arrangements between regulators'.<sup>272</sup> A harmonised insider dealing regulation amongst Member States facilitates co-operation between national jurisdictions. Under Article 8, each State is obliged to designate the administrative authority competent to apply the provisions adopted in conformity with the Directive. Member states are made responsible for giving the authority the necessary supervisory and investigatory powers. Article 10 is designed to promote co-operation between the administrative authorities in each State. Cross-border insider dealing can be investigated in State A on behalf of State B.<sup>273</sup> Article 10 also envisages exchange of information for the purposes of the State's insider dealing law and in Article 11 there is a special provision for agreements between the Community and non-member countries on the matters governed by the Directive.

It should be noted that a Member State may refuse to act on a request for information on two circumstances:<sup>274</sup>

*(a) where communication of the information might adversely affect the sovereignty, security or public policy of the State addressed;*

*(b) where judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the State addressed or where final judgement has already been passed on such persons for the same actions by the competent authorities of the state addressed.*

Similar provisions exist in the Companies Act 1989, ss. 82-91. On 1 October 1991 the Insider Trading Convention of the Council of Europe<sup>275</sup> came into force having been ratified by the necessary 3 Member States (Norway, Sweden, and the United Kingdom). The Convention<sup>276</sup> represents an important attempt to facilitate multilateral co-operation for the enforcement of laws prohibiting insider dealing.<sup>277</sup> Its aim was to create mutual assistance by exchanges of information, to enable supervision of securities markets and to establish whether persons carrying out financial transactions are or are not insiders. According to the Protocol to the Insider Trading Convention, the State Parties which are members of the EC are to give precedence to the Directive over that Convention.<sup>278</sup> The Directive and the Convention are entirely compatible, reflecting according to Brown<sup>279</sup>, the involvement with observer status which the Commission of the European Communities had in the elaboration of the Insider Trading Convention. The definitions of terms used in the Convention, and especially the definition of inside information are broader in scope than the definitions of the EC Directive.<sup>280</sup>

Under article 2 of the Convention, the main undertaking of the Contracting States is "to provide each other with the greatest possible measure of mutual assistance in the exchange of information relating to matters establishing or giving rise to the belief that irregular operations of insider trading have been carried out." Assistance should be taken to include providing access to information in the files of the requested authority, taking evidence of persons and obtaining documents. Each State must designate, according to article 4, authorities responsible for submitting and for receiving requests for assistance. In addition, it is provided that the execution of the requests is carried out in accordance



with the law of the Contracting Party where the requested authority operates and, in the absence of specific provisions, the latter may apply the rules laid down by national law for obtaining evidence [art. 6(1)&(2)]. These provisions may not prejudice the rights accorded to the defendant by national law [art. 6(3)]. In this context, sanctions laid down for breaches of professional secrecy shall not apply in regard to the information provided compulsorily by witnesses in the course of an enquiry [art. 6(2)].

The undertaking of the requested authority to supply information is conditional upon the facts on which the request is based constituting insider dealing as defined by the Convention and, in addition, constituting "in each State an irregularity as regards the rules of both States."<sup>281</sup> This requirement of "dual irregularity"<sup>282</sup> means that the facts must constitute according to the laws of both the requested and the requesting States a criminal offence or an infraction subject to administrative, disciplinary or civil sanctions, but not an infraction for which damages is the only civil sanction.<sup>283</sup> Reference to "disciplinary sanctions" suggests that the communication network could be used for the enforcement of self-regulatory rules. According to Tridimas, a case may be envisaged where a Contracting Party requests from another information which the latter can obtain from the regulatory authorities of a third State pursuant to an existing agreement between the third State and the requested State and, on the condition that the requirement of dual irregularity is fulfilled, such a request is not beyond the scope of the Convention as the latter does not presuppose that the information requested is already in the hands of the requested authority or within the territory of the State.<sup>284</sup>

The scope of application of the Convention is limited in two ways: Firstly, by the requirement of "dual irregularity". It should be noted that Article 10 of the EC Directive specifically requires the exchange of

information upon the request of a Member State even where the relevant action is not prohibited by the law of the requested State. Secondly, it has been observed<sup>285</sup> that the Convention "solely incorporates an undertaking of 'passive assistance'", by merely imposing upon a State the obligation to provide information in connection with the suspected violation of the insider trading laws of another State if the latter so requests. The authorities of a Contracting State are not required to inform the authorities of another State that a breach of the insider trading law of the latter is suspected. This type of undertaking is often referred to as "active assistance".<sup>286</sup>

The Convention has had a rather poor take-up which may reflect the existence of efficient informal means of exchanging business regulatory information, the recent expansion of arrangements for the exchange of information about insider dealing, and the presence in Article 10 of the Directive of provisions requiring the exchange of information between business regulators.<sup>287</sup>

As regards prosecution, the Convention seeks to ensure that the proper procedures have been followed before the information transmitted to the requesting authority is used in criminal proceedings. The reason is that under the Insider Trading Convention, the information is obtained by administrative means whereas "*actes internationaux d'instruction*" are normally subject to the procedures of the European Convention on Mutual Assistance in Criminal Matters.<sup>288</sup> It should be stressed at this point that the Convention on Mutual Assistance contains no requirement that the action which is the subject of the prosecution should be criminal in both the requesting and the requested State before assistance can be given.<sup>289</sup> Article 12 of the Insider Trading Convention requires State Parties to afford each other the widest possible measure of assistance in



criminal matters relating to offences involving insider trading, but this obligation operates without prejudice to the application of the European Convention on Criminal Assistance in Criminal Matters. Given that the latter Convention has had a much higher take-up (22 parties)<sup>290</sup> the investigative trail will be capable of being followed in some of the EU Member States that have not yet ratified the Insider Trading Convention.

A further optional undertaking is provided by Article 3 of the Insider Trading Convention:

*"Each Party, may, by a declaration to the Secretary General of the Council of Europe, undertake to provide other Parties, subject to reciprocity, with the greatest possible measure of mutual assistance in the exchange of information necessary for surveillance of operations carried out in the organised stock markets which could adversely affect equal access to information for all users of the stock market or the quality of the information supplied to investors in order to ensure honest dealing."*

This is an attempt to extend the scope of the application of the Convention to other fraudulent operations such as investment fraud and market manipulation which is severely obstructed by the requirement of "dual irregularity".

The United Kingdom has also become a party to the Council of Europe Convention on Extradition<sup>291</sup> which requires [article 2(1)] that, before extradition is granted, the offence be one which is punishable under the laws of both the requesting and the requested party by deprivation of liberty for at least one year. If this condition is satisfied, subject to the rest of that Convention, State Parties are obliged to extradite. This measure will undoubtedly increase the efficiency of prosecution of insider trading in EU Member States. The problems of interstate co-operation and enforcement both at an EU and an International level will be further examined in the final chapter.

## VIII. Conclusion

One of the main shortcomings of the Criminal Justice Act 1993 seems to be that it did not alter any of the sanctions or enforcement procedures, although the courts, in interpreting the previous legislation, had been prepared to find non-executed contracts based on inside information unenforceable (*Chase Manhattan Equities Ltd v Goodman*, Ch D, BCC [22-7-91]). The need to avoid upsetting the market and to protect the certainty of transactions has prevailed. The financial market policy considerations that dictated the adopted solution are undeniably important but could possibly have some unfair results on victims of insider dealing. The possibility of prejudicing the rights of persons who have suffered loss as a result of the acts of insiders could be significantly reduced by affording civil remedies to these individuals. As Dine has pointed out both the criticism of the use of the criminal law and the possibility of substituting civil remedies have apparently been ignored.<sup>292</sup> It could be doubted, therefore, whether the use of criminal law is sufficient to promote compliance as expressly required by the Directive [Article 13].

According to one commentator the new Act has emasculated the concept of insider as liability focuses not on the relationship with the issuer but on the nature of the information held, thus, extending liability beyond the range of individuals potentially liable to a company under the civil law for breach of confidence.<sup>293</sup> This criticism does not seem justified. The broader definition of the insider adopted by the Act reflects the international tendency of insider legislation to shift from the company law - fiduciary approach, which perceives as insiders persons with fiduciary duties, to the financial market approach which sets the



protection of the integrity of the market<sup>294</sup> as the main priority of the insider dealing legislation. Liability will also arise in respect of a broader range of information, given that there is no requirement that the information should be confidential to the company. The adoption of a simple criminal offence of acting in "breach of fiduciary duty" even if it were supported by detection mechanisms set up by companies<sup>295</sup> would unduly restrict the scope of the legislation.

The wide definition of insider dealing has forced the government to adopt ever more complicated defences resulting in "so many get-outs and defences that it is likely that even fewer people will be referred for prosecution and that there will be more acquittals than previously."<sup>296</sup>

The Act has taken positive steps to follow its statement in the Consultative Document of 1990 according to which the drift net of liability should catch anyone with an informational advantage,<sup>297</sup> focusing on the possession of information as is dictated by the current insider trading regulation theories.<sup>298</sup>

Finally, it should be recognised that the implementation provisions of the Criminal Justice Act 1993, in general terms, reflect the Directive well and, at the same time, do away with some of the deficiencies of the previous legislation. The efficiency of the provisions remains to be seen in practice especially in the light of the recent reform of the financial regulation. The Criminal Justice Act 1993, as has already been remarked, must be confronted as a *compromise statute*. Perceiving the task of regulating insider dealing as 'the art of the possible' would weaken the strength of the commonplace remark that there is still room for improvement.

## NOTES

- <sup>1</sup> Amy E. Stutz, "A New Look at the European Economic Community Directive on Insider Trading", *Vanderbilt Journal of Transnational Law*, Vol. 23:1:135 1990, at p. 155
- <sup>2</sup> Michael Crystal & Stephen Atherton, *Insider Trading: The Laws of Europe, The United States and Japan*, Edited by Em. Gaillard, KLUWER 1992, p. 171
- <sup>3</sup> idem
- <sup>4</sup> Blair William, "The Reform of Financial Regulation in the U.K.", *Journal of International Banking Law*, 1998, p. 43
- <sup>5</sup> McDowall Robert Cripps, "Financial Services Authority - Progress or Pragmatism?", *Journal of International Banking Law*, 1998, p.123, see also Sarker Rinita, "Reform of the Financial Regulatory System", *The Company Lawyer*, Vol 19, No 1, 1998, Alcock Alistair, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 70, Blair *op. cit.* p. 43
- <sup>6</sup> McDowall *op. cit.* p. 123
- <sup>7</sup> *Financial Times*, 17 October 1997, cited by Blair *op. cit.* p. 13
- <sup>8</sup> *The Times*, 15 October 1997
- <sup>9</sup> *Financial Times*, 13 october 1997, cited by Blair *op. cit.* p. 13, see also critique by Alcock
- <sup>10</sup> Blair, *op. cit.* p. 13
- <sup>11</sup> "Catching London's culprits", *The Economist*, April 3rd 1993, p. 20
- <sup>12</sup> idem
- <sup>13</sup> idem
- <sup>14</sup> idem and "Turfing insider-traders out", *The Economist*, July 16th-22nd 1994, pp. 79-80
- <sup>15</sup> Alastair Brown, "Insider Dealing and the Criminal Law", in "*Insider Dealing: Papers presented at a seminar, Edinburgh, 27 August 1993*", Edited by H. L. MacQueen, The David Hume Institute, Hume Occasional Paper No 41, p. 7
- <sup>16</sup> idem
- <sup>17</sup> quoted by Prof. J. Murray at p. 27 of 'The New Insider Dealing Law: A Critique' in "*Insider Dealing: Papers presented at a seminar, Edinburgh, 27 August 1993*", Edited by H. L. MacQueen, The David Hume Institute, Hume Occasional Paper No 41
- <sup>18</sup> Prof. J. Murray, 'The New Insider Dealing Law: A Critique' in "*Insider Dealing: Papers presented at a seminar, Edinburgh, 27 August 1993*", Edited by H. L. MacQueen, The David Hume Institute, Hume Occasional Paper No 41, p. 20, see also Eleftheriadis
- <sup>19</sup> see Eleftheriadis for a recent review of Direct Effect issues.



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<sup>20</sup> Murray, *op. cit.* p. 20

<sup>21</sup> The term '*tippee*' was first used by Professor Louis Loss of Harvard Law School, the '*guru*' of securities regulation. The Oxford English Dictionary has credited him with this fact.

<sup>22</sup> Attorney General's Reference (No. 1 of 1988) [1989] 1 A. C. 971

<sup>23</sup> s. 57(1)(b)

<sup>24</sup> "*if and only if*": s. 57(2)

<sup>25</sup> s. 57(2), *Palmer's Company Law*, R. 51: August 1993, para 11.134, p. 11077

<sup>26</sup> Barry Rider & Michael Ashe, "The Insider Dealing Directive", in *EC Financial Market Regulation and Company Law*, edited by: Mads Andenas & Dr. Stephen Kenyon-Slade, London Sweet & Maxwell 1993, p. 227

<sup>27</sup> Commentators seem to agree on the point that the access to information must be a direct *corollary* of the exercise of their employment, because the Directive uses again the terms "*by virtue*" instead of "*on the occasion*". E. Gaillard & I. Pingel, "Les opérations d'initiés dans la Communauté économique européenne", *Revue Trim. Dr. Europ.* 26(2) avr.-juin 1990, pp.329-355

<sup>28</sup> Barry Rider & Michael Ashe, *op. cit.* p. 227

<sup>29</sup> s. 57

<sup>30</sup> defined in s. 60(2)

<sup>31</sup> J. Dine, "Implementation of the EC Insider Trading Directive in the UK", *The Company Lawyer*, Vol. 14, No 3, p. 61

<sup>32</sup> J. Murray, *op. cit.* p. 20

<sup>33</sup> P. L. Davies, "The European Community's Directive on Insider Dealing: From Company Law to Securities Markets Regulation?", *Oxford Journal of Legal Studies*, vol. 11, spring 1991

<sup>34</sup> *idem*, at p. 92

<sup>35</sup> Dine, *op. cit.* p. 62, The Governments consultative document on the proposed legislation (DTI, *The Law on Insider Dealing*, 1989, para. 2.24) rejected an even wider approach: '*An insider is a person in possession of inside information*'. This approach was '*likely to cause damaging uncertainty in the markets, as individuals attempted to identify whether or not they were covered.*'

<sup>36</sup> *idem*

<sup>37</sup> The phrase 'in the exercise of' was replaced in the final text by the 'by virtue of' requirement. See the Commission's Proposal and Amended Proposal: COM(87) 111 final,

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Art2 and COM(88) 549 final, Art1(1).

<sup>38</sup> Davies at p. 466 of Gower's *Principles of Modern Company Law*, sixth edition (by Paul L. Davies) Sweet & Maxwell 1997

<sup>39</sup> Dine, *op. cit.* p. 62, see also J. Dine, "Insider Trading: the why? and how?", *European Financial Services Law*, March 1997, p. 76, Davies at p. 465 of Gower's *Principles of Modern Company Law*, sixth edition (by Paul L. Davies) Sweet & Maxwell 1997, endorses the same view.

<sup>40</sup> Insider Dealing Act 1985, s.2 (as amended by the Financial Services Act 1986, s. 173)

<sup>41</sup> *Palmer's Company Law*, R. 51: August 1993, para 11.134, p. 11077

<sup>42</sup> Keith Wotherspoon, 'Insider Dealing - The New Law: Part V of the Criminal Justice Act 1993', *The Modern Law Review*, [Vol. 57, May 1994] p.425

<sup>43</sup> See the DTI, *The Law on Insider Trading: A Consultative Document* (December 1989), para 2.26.

<sup>44</sup> Wotherspoon, *op. cit.*, p.425.

<sup>45</sup> Rider & Ashe, *op. cit.* p. 229

<sup>46</sup> A shadow director is defined as a person in accordance with whose directions or instructions the directors of the company are accustomed to act, see Companies Act 1985, s.741(2).

<sup>47</sup> s. 57(2)(b)

<sup>48</sup> Communicating the information may itself be an offence: s. 52(2)(b)

<sup>49</sup> unreported, Inner London Crown Court, June 1991, cited by Rider, *supra* note 17, p. 240, note 46

<sup>50</sup> Rider, *op. cit.* p. 240, note 46

<sup>51</sup> *idem*

<sup>52</sup> [1989] 1 A.C. 971, *Palmer, op. cit.* p. 11077, see also Murray, *op. cit.* p. 19

<sup>53</sup> Attorney-General's reference (no.1 of 1988) [1989] A.C. 971, at p. 991B

<sup>54</sup> *Palmer, op. cit.* p. 11078

<sup>55</sup> Dine, *op. cit.* p. 62

<sup>56</sup> Art. 4

<sup>57</sup> DTI Consultative Document, *op.cit.* n7, para 2.28

<sup>58</sup> Wotherspoon, *op. cit.*, p.427.

<sup>59</sup> Davies at p. 467 of Gower's *Principles of Modern Company Law*, sixth edition (by Paul L. Davies) Sweet & Maxwell 1997

<sup>60</sup> *Palmer, op. cit.* p. 11073



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<sup>61</sup> s. 56(1)

<sup>62</sup> the term "securities" is defined in s. 54, see below

<sup>63</sup> Palmer, *op. cit.* p. 11073, note 22

<sup>64</sup> Defined in s. 60(2) as "any company, public sector body or individual by which or by whom the securities have been or are to be issued."

<sup>65</sup> See Attorney-General's Reference (No. 1 of 1988) [1989] 1 A.C. 971.

<sup>66</sup> s. 60(4)

<sup>67</sup> s. 56(1)(b)

<sup>68</sup> (89/592/EEC) Art. 1 (1)

<sup>69</sup> Palmer, *op. cit.* p. 11074

<sup>70</sup> Alistair Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 70

<sup>71</sup> *idem*

<sup>72</sup> *idem*

<sup>73</sup> *idem*

<sup>74</sup> Rider & Ashe, *op. cit.* p. 225

<sup>75</sup> For an instance where the Court of Appeal identified a jury's confusion on the issue of specificity under the 1985 Act, see *R v Cross* [1991] BCLC 125, at 132, see also Keith Wotherspoon, 'Insider Dealing - The New Law: Part V of the Criminal Justice Act 1993', *The Modern Law Review*, [Vol. 57, May 1994]

<sup>76</sup> Rider & Ashe, *op. cit.* p. 225

<sup>77</sup> s. 56(1)(c)

<sup>78</sup> N. Walmsley, "Insider Dealing: The Well-connected's Crime", *Journal of International Banking Law*, [1993] 12, p. 509

<sup>79</sup> s. 58(1)

<sup>80</sup> Alistair Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 71

<sup>81</sup> *idem*

<sup>82</sup> *idem*, by the Draft Traded Securities (Disclosure) Regulations 1993, in conformity with Article 7 of the Directive

<sup>83</sup> See Criminal Justice Bill, 19 November 1992, HL Bill 45, cl 33, see also K. Wotherspoon, *op.cit.* p. 422.

<sup>84</sup> A. Brown, *op.cit.* p. 11, at an earlier stage of the Bill the expression "made public" was not defined and it was proposed to issue Treasury guidelines on its meaning, also J. Dine

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*op.cit.* p. 76

<sup>85</sup> "Investment analyst wins back his reputation", *The Herald*, p. 1, 17/2/1994

<sup>86</sup> A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 70, the definition that existed in the Insider Dealing Act s. 10 rendered the word "unpublished" practically otiose.'

<sup>87</sup> s. 58(2)

<sup>88</sup> defined in s. 69(1)

<sup>89</sup> Defined in s. 60(1)

<sup>90</sup> Palmer, *op.cit.* p. 11075

<sup>91</sup> see Economic Secretary's remarks in HC Dep vol 235, col 298 (12 January 1994)

<sup>92</sup> *idem*

<sup>93</sup> A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 71

<sup>94</sup> *idem*

<sup>95</sup> The phrase is that used by the US Second Circuit Court of Appeals in *SEC v Texas Gulf Sulphur Co* (1968) 401 F 2d 833, at 853, n 17.

<sup>96</sup> s. 58(2)(c) i.e. any securities (i) to which the information relates, or (ii) of an issuer to which the information relates

<sup>97</sup> A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 71

<sup>98</sup> s. 58(3)

<sup>99</sup> A. Brown, *op.cit.* p. 12

<sup>100</sup> Brown, *op. cit.*, p. 12

<sup>101</sup> Norman Barry, "Witchcraft and Insider Dealing", in *Insider Dealing: Papers presented at a seminar, Edinburgh, 27 August 1993*, Edited by H. L. MacQueen, The David Hume Institute, Hume Occasional Paper No 41, p. 32

<sup>102</sup> A. Brown, *op.cit.* p. 12

<sup>103</sup> A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 71

<sup>104</sup> *idem*

<sup>105</sup> N. Barry, *op.cit.* p. 32

<sup>106</sup> London Stock Exchange, *Guidance on the Dissemination of Price Sensitive Information*, February 1995.

<sup>107</sup> A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*,



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Vol 15, No 3, p. 71

108 K. Wotherspoon, *op.cit.* p. 424.

109 s. 56(1)(d)

110 Palmer, *op.cit.* p. 11076

111 Take-over Code Note on Rule 2.2, cited by Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 71

112 K. Wotherspoon, *op.cit.* p. 424.

113 Rider & Ashe, *op.cit.* p. 227

114 See s 10(b), 1985 Act.

115 s. 56(2)

116 A. Brown, *op.cit.* p. 13

117 K. Wotherspoon, *op.cit.* p. 424.

118 N. Barry, *op.cit.* p. 32

119 s. 52(1)

120 s. 57(1)(b)

121 Palmer, *op.cit.* p. 11078

122 *idem*

123 s. 57

124 Davies at p. 460 of Gower's *Principles of Modern Company Law*, sixth edition (by Paul L. Davies) Sweet & Maxwell 1997

125 s. 54(1)

126 Schedule 2, para. 1: "Shares and stock in the share capital of a company (defined in s. 60(3) as not covering any public sector bodies)"

127 Sched. 2, para. 2: "Any instrument creating or acknowledging indebtedness which is issued by a company or public sector body, including, in particular, debentures, debenture stock, bonds and certificates of deposit ("debt securities")" irrespective of whether they are issued by a "company" or a "public sector body".

128 Sched. 2, para. 3: "Any right (whether conferred by warrant or otherwise) to subscribe for shares or debt securities ("warrants")"

129 Sched.2, para. 4: 'a "depository receipt" means a certificate or other record (whether or not in the form of a document) (a) which is issued by or on behalf of a person who holds any relevant securities of a particular issuer; and (b) which acknowledges that another person is entitled to rights in relation to the relevant securities or relevant securities of the same kind."

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<sup>130</sup> Sched. 2, para. 5: "Any option to acquire or dispose of any security falling within any other paragraph of this Schedule."

<sup>131</sup> Sched. 2, para. 6: "Rights under a contract for the acquisition or disposal of relevant securities under which delivery is to be made at a future date and at a price agreed when the contract is made."

<sup>132</sup> Sched. 2, para. 7: "Rights under a contract which does not provide for the delivery of securities but whose purpose or pretended purpose is to secure a profit or avoid a loss by reference to fluctuations in (a) a share index or other similar factor connected with relevant securities; (b) the price of particular relevant securities; or (c) the interest rate offered on money placed on deposit." The definition is in similar terms to Financial Service Act 1986, Sched. 1, para. 9, but slightly broader in also covering contracts based on fluctuations in the interest rate offered on money placed on deposit. See *City Index Ltd v Leslie* [1991] BCLC 643 for a discussion of the nature of a contract for differences.

<sup>133</sup> s. 54(2) & s. 64(1,2)

<sup>134</sup> Palmer, *op.cit.* p. 11073

<sup>135</sup> J. Murray, *op.cit.* p. 20; the DTI Consultative Document, '*The Law on Insider Dealing*' (December 1989), (hereafter DTI Consultative Document), para 2.17, noted that the Government was not aware of any substantiated claims of improper dealing in non-company securities.

<sup>136</sup> gilts=british government securities (fixed-interest securities or stock issued by the British government in the form of Exchequerstocks or Treasury stocks, assumed to be safe investment and unlikely to default on interest or on principal repayments), *English Law Dictionary*, Peter Collin Publishing; this change has been called for particularly with respect to gilts where there have been allegations of significant dealings as a result of a leak about ERM entry in October 1990 and again in September 1992 ahead of the Government's £7.27bn foreign currency loan.

<sup>137</sup> J. Murray, *op.cit.* p. 20

<sup>138</sup> A. Alcock. "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 70, on the potential impact of the exclusion of currency and commodity derivatives, see Clifford Chance, *EC Financial Services Newsletter* (November 1993) p 23.

<sup>139</sup> Abbreviation for London International Financial Futures and Options Exchange

<sup>140</sup> A. Alcock. "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 70

<sup>141</sup> S.I. 1994 No. 187, art. 10, as amended by S.I. 1996 No. 1561.



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- 142 HC Debs, Session 1992-93, Standing Committee B, col 164-165, 10 June 1993.
- 143 i.e. a State within the European Union (now comprising the Republics of Austria and Finland) and the Republic of Iceland, the Kingdoms of Norway and Sweden and the Principality of Lichtenstein.
- 144 B. Hannigan, *Insider Dealing*, 2nd Edition, Longman 1994, pp. 97-98
- 145 A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 70
- 146 *idem*
- 147 A. Brown, *op. cit.*, p. 10
- 148 A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 68
- 149 A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 69
- 150 [1975] 2 All ER 684 at p. 686
- 151 J. Dine, *op. cit.*, p. 62
- 152 A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 69
- 153 J. Dine, *op. cit.*, p. 62
- 154 B. Hannigan, *Insider Dealing*, 2nd Edition, Longman 1994, p. 93.
- 155 *idem*
- 156 Unreported but see *Financial Times*, 1 May 1991 and 16 June 1992, also *Chase Manhattan Equities Ltd v Goodman* [1991] BCLC 897.
- 157 B. Hannigan, *op.cit.* p.93.
- 158 A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 69
- 159 K. Wotherspoon, *op.cit.* p. 428.
- 160 curiously including NASDAQ by Draft Insider Dealing (Regulated Markets and Securities) Order 1993 as Alcock points out, *supra* note 52, at p. 69
- 161 A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 69
- 162 A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 69
- 163 this insertion at the Committee stage was effected at the demand of corporate financiers, the Law Society's Company Law Committee and sympathetic Members of

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Parliament, see K. Wotherspoon, *op.cit.* p. 428.

<sup>164</sup> A. Alcock, "Insider Dealing - how did we get here?", *The Company Lawyer*, Vol 15, No 3, p. 69

<sup>165</sup> J. Murray, *op.cit.* p.22

<sup>166</sup> The case, which was a civil claim, failed.

<sup>167</sup> *idem*

<sup>168</sup> J. Murray remarks for off-market dealings: '*Provided the limits on ordinary rules as to fraud or misrepresentation are not breached, parties may deal on an unequal basis in all such cases. For my part, I find it difficult to see why the behaviour in question deserves to be criminalised in one case but not in the other. I would find it easier to accept the dichotomy if civil remedies were readily available in relation to insider dealing.*'

J. Murray, *op.cit.* p. 23

<sup>169</sup> see s.57(1)

<sup>170</sup> K. Wotherspoon, *op.cit.* p. 428.

<sup>171</sup> see s.53(1)(a),(c).

<sup>172</sup> Abbreviation for the Swedish Options Market, which is based in Stockholm and London; it opened in 1985.

<sup>173</sup> A. Alcock, *op.cit.* p.69.

<sup>174</sup> Art. 5

<sup>175</sup> Davies at p. 457 of *Gower's Principles of Modern Company Law*, sixth edition (by Paul L. Davies) Sweet & Maxwell 1997

<sup>176</sup> J. Dine, *op.cit.* p. 62.

<sup>177</sup> Palmer, *op.cit.* p. 11083.

<sup>178</sup> K. Wotherspoon, *op.cit.* p. 429.

<sup>179</sup> A. Alcock, *op.cit.* p.68.

<sup>180</sup> K. Wotherspoon, *op.cit.* p. 429, if the recipient did in fact receive inside information when encouraged to deal, the individual divulging that information may also have committed the disclosure offence under s 52(2)(b).

<sup>181</sup> K. Wotherspoon, *op.cit.* p. 429.

<sup>182</sup> Palmer, *op.cit.* p. 11082.

<sup>183</sup> *idem*

<sup>184</sup> K. Wotherspoon, *op.cit.* p. 429.

<sup>185</sup> J. Dine, *op.cit.* pp. 62-63

<sup>186</sup> *idem*



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187 Rider & Ashe,*op.cit.* p.232

188 Insider Dealing Act 1985, ss.3(1)(a), 4(1), 5(2)

189 J. Dine,*op.cit.* p.63, points out that the approach adopted mirrors a suggestion made by the Law Society ('Report by a Working Party established jointly by the Law Society's Standing Comitee' (October 1978)):

*"it shall be a defence to show that the accused did not deal for the purpose of exploiting the inside information in his posession."*

190 A. Alcock,*op.cit.* p.72

191 ss. 53(1)(b), (2)(b) and (6)

192 Palmer,*op.cit.* p. 11085

193 "Investment analyst wins back his reputation", *The Herald*, p. 1, 17/2/1994

194 A.Brown,*op.cit.* p. 13

195 *idem*

196 A. Alcock,*op.cit.* p.72

197 *idem*

198 Palmer,*op.cit.* p. 11085

199 A. Alcock,*op.cit.* p.72

200 *idem*

201 *idem*

202 "Catching London's culprits", *The Economist*, April 3rd 1993, p. 20

203 defined in s, 60(1)

204 defined in s. 59

205 Palmer,*op.cit.* p. 11086

206 s. 53(3)(a) & 52(3)

207 s. 53(3)(b)

208 s. 53(3)(b)

209 A.Brown,*op.cit.* p. 14

210 A.Brown,*op.cit.* p. 14, supports that the term "special defence" is an unhappy one, because those words have a particular meaning in Scots criminal law, to do with the notice which must be given of certain defences such as alibi or self defence.

211 para. 1(2)

212 defined in s. 60(1)

213 such as the Association of International Bond Dealers (AIBD). Schedule 1, para. 1(2)(a) talks of an "international securities and self-regulating organisation" approved under the

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Financial Services Act 1986, Sched. 1, para. 25B.

214 A.Brown, *op.cit.* p. 14-15

215 Palmer, *op.cit.* p. 11087

216 A.Alock, *op.cit.* p.71

217 Insider Dealing Act 1985, ss. 3(1)(c), 4(1), 5(2)

218 Insider Dealing Act 1985, ss. 3(1)(c), 4(1), 5(2)

219 Sched. 1, para. 4

220 A.Alcock, *op.cit.* p.71

221 Sched. 1, para. 2(1)(a)&(b)

222 Sched. 1, para. 3

223 Palmer, *op.cit.* p. 11088

224 Insider Dealing Act 1985, s. 3(2)

225 A.Brown, *op.cit.* p. 15

226 Financial Services Act 1986, section 48

227 Palmer, *op.cit.* p. 11089

228 A.Brown, *op.cit.* p. 15

229 s. 61

230 "Catching London's culprits", *The Economist*, April 3rd 1993, p. 20, Hannigan (*op. cit.* pp, 118 *et seq*) suggests that from 1980 up to the end of the first quarter of 1994 there had been some 33 recorded cases brought against some 51 individuals, of whom 14 pleaded guilty and only 9 of whom were convicted after pleading not guilty.

231 A.Brown, *op.cit.* p. 7

232 A.Brown, *op.cit.* p. 7

233 A.Brown, *op.cit.* p. 7

234 A.Brown, *op.cit.* p. 7

235 John M Naylor, "The Use of Criminal Sanctions by UK and US Authorities for Insider Trading: How Can the Two Systems Learn from Each Other?" Part I, *The Company Lawyer*, Vol.11, No.3, p. 58

236 Ross Cranston, "Insider Dealing Again", *International Business Law*, 1990, p. 447

237 "Turfing insider-traders out", *The Economist*, July 16th-22nd, 1994, pp. 79-80

238 *idem*

239 "Catching London's culprits", *The Economist*, April 3rd 1993, p. 20

240 "Catching London's culprits", *The Economist*, April 3rd 1993, p. 20

241 "Turfing insider-traders out", *The Economist*, July 16th-22nd, 1994, pp. 79-80, the



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Serious Fraud Office has the responsibility of bringing charges for insider dealing. (see previous paragraph)

242 *idem*

243 *idem*

244 23 European Human Rights Reports 313

245 Davies at p. 474 of Gower's *Principles of Modern Company Law*, sixth edition (by Paul L. Davies) Sweet & Maxwell 1997

246 [1993] 2 All E.R. 789, C.A.

247 A.Alcock, *op.cit.* p.68, who cites: *Prudential Assurance Co Ltd v Newman Industries (No 2)* [1982] Ch 204 and *Caparo Industries Plc v Dickman* [1990] 2 AC 605

248 see INTRODUCTION, also J. Murray, *op.cit.* p. 23

249 J. Murray, *op.cit.* p. 23

250 J. Murray, *op.cit.* p. 23

251 A.Alcock, *op.cit.* p.68, who cites: *Seager v Copydex* [1967] 2 All ER 415, *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443, *Boardman v Phipps* [1967] 2 AC 46

252 A.Alcock, *op.cit.* p.68, who cites: *Gluckstein v Barnes* [1900] AC 240, *Selangor United Rubber Estates Ltd v Cradock (No 3)* [1968] 2 All ER 1073, *Belmont Finance Corporation Ltd v Williams Furniture Ltd* [1979] Ch 250

253 J. Murray, *op.cit.* p. 24

254 *Prudential Assurance Company Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257, [1980] 2 All ER 841, *resv* [1982] Ch 204, [1982] 1 All ER 354.

255 A.Alcock, *op.cit.* p.68

256 Leo Herzel & Leo Katz, "Insider Trading: Who Loses?", (1987) 165 *Lloyds Bank Review* 15

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260 [1902] 2 Ch 421

261 J. Murray, *op.cit.* p. 22

262 J. Murray, *op.cit.* p. 22

263 Rider & Ashe, *op.cit.* p. 235

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- 264 R. Cranston, *op.cit.* p. 447
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- 266 *idem*
- 267 Insider Dealing Act 1985, s. 8(3)
- 268 s. 63(2)
- 269 *Chase Manhattan Equities Ltd v Goodman*, Ch D, *British Company Cases* [22-7-91]
- 270 s. 62
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- 272 A. Brown, *op.cit.* p. 16 who cites: McClean, D, (1992) "*International Judicial Assistance*", Oxford: Clarendon Press.
- 273 Rider & Ashe, *op.cit.* p. 237
- 274 Article 10(2)
- 275 Convention on Insider Trading, Council of Europe, No. 130
- 276 see also: John P. Lowry, "The International Approach to Insider Trading: The Council of Europe's Convention", *Journal of Business Law*, 1990, pp. 460- 468
- 277 Takis Tridimas, Convention on Insider Trading, *European Law Review*, October 1991, p. 435
- 278 A. Brown, *op.cit.* p. 16
- 279 *idem*
- 280 T. Tridimas, *op.cit.* p. 438
- 281 art. 7(2)
- 282 T. Tridimas, *op.cit.* p. 441
- 283 Explanatory Report on the Convention, p. 12
- 284 T. Tridimas, *op.cit.* p. 441
- 285 *idem*
- 286 *idem*
- 287 A. Brown, *op.cit.* p. 17
- 288 Council of Europe, No. 30
- 289 A. Brown, *op.cit.* p. 17
- 290 *idem*
- 291 *idem*
- 292 J. Dine, *op.cit.* p. 63
- 293 N. Walmsley, *op.cit.* p. 512
- 294 see: P. L. Davies, "The European Community's Directive on Insider Dealing: From



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Company Law to Securities Markets Regulation?", *Oxford Journal of Legal Studies*, vol. 11, spring 1991

<sup>295</sup> J. Dine, *supra* note 26, p. 80

<sup>296</sup> Alistair Darling, the chief Labour Spokesman on Standing Committee B, quoted by A. Alcock, *op.cit.* p.72

<sup>297</sup> cited by N. Walmsley, *op.cit.* p. 512

<sup>298</sup> see INTRODUCTION & 1st CHAPTER

## D. 2. Insider Dealing Regulation in Greece

### I. Overview

The first reported cases from criminal suits against sellers of securities for cheating the buyer through withholding or not disclosing information as to the company's financial situation were confined to securities transfers outside the stock exchange.<sup>1</sup> The law invoked in such cases is the law, civil or criminal, governing sales. This law has not been affected by the insider law promulgated in 1988 as amended by the Presidential Decree 53/1992.

The issue of insider trading was specifically addressed for the first time in Greece in 1988, when Article 30 of Law 1806/1988 (hereinafter the 'Law') amending the existing legislation governing stock exchanges and introducing both insider criminal liability and an indirect take-over publicity was adopted.

Although the law became effective on September 20, 1988, prior to the final adoption of the EC Directive 89/592 of November 13, 1989, coordinating regulations on insider dealing, the provisions of the Law relevant to insider trading are similar to the basic principles of the Directive. Furthermore the Ministry of National Economy has already adapted the provisions of the Greek legislation to the Directive in accordance with Article 14, pursuant to which each Member State should take the necessary measures to comply with the Directive before June 1, 1992. The necessary amendment took the form of a Presidential Decree (53/92), it repeats in essence the provisions of the above Directive with few changes and was enacted in February 1992.<sup>2</sup>

Presidential Decree 53/1992 (hereinafter PD 53/92) enacted into



national law the Insider Dealing Directive without reiterating the rationales for prohibiting Insider Dealing stated in the preamble of the Directive, namely the preservation of an orderly and fair market free of abuse that does not confer on a privileged part of market players and unfair advantage over the others.

The relevant provisions of the PD 53/92 are almost a copy of the Directive, following the same line as to the definition of inside information, namely that this information must be precise, non-public, pertaining either to the issuer or the security, and if made public must have a significant effect on the price. Nonetheless, the PD does not define what is meant by the words significant effect over the price of the security. The inference can be readily drawn that Greek courts, when a relevant case is brought before them, are going to accept the definition that significant information is the 'information that would drive the market price of the security concerned towards a new price equilibrium.'<sup>3</sup>

Article 30 of Law 1806/1988, which is somewhat narrower in scope compared with PD 53/92, remains in force creating a duality in the Greek insider dealing legislation with both advantages and disadvantages.

## **II. Definition of Insider Trading**

### **1. Categories of Insiders**

#### *A. Primary Insiders*

According to paragraph 1 of Article 30 of the Law 1806/1988, *primary* or *direct* insider is "anyone who uses confidential information which has come to his knowledge by virtue of his temporary or permanent rendering of services in any capacity to an 'enterprise', to purchase or sell either himself or through another person, stock-exchange values of such

'enterprise' with the object of obtaining *a significant financial benefit* for himself or a third party or to cause a significant loss to a third party".

It should be noted that the PD 53/92 follows the Directive in avoiding the pitfall of '*benefit*' in the objectives of insiders.

The Law uses broad wording in defining the persons that are potentially criminally liable, and covers any person who uses confidential information about an enterprise 'by virtue of his permanent or temporary rendering of services' to such enterprise or for such enterprise. The Law does not specify which 'services' give rise to punishment of potential offenders and, thus, covers all personnel of an enterprise - irrespective of an individual's duties - including insiders within the '*managerial nucleus*'<sup>4</sup> of the enterprise as well as those exterior to it. It also includes persons who are not employees *e.g.* lawyers, financial advisers etc. Although this definition of insiders is broader in this respect than the definition of Article 2 of the EC Directive and PD 53/92, article 30 does not appear to cover shareholders of the issuing company, since shareholders do not 'render services' to an enterprise.<sup>5</sup> At this point Georgakopoulos remarks that "if the insider alone or with others makes a decision then he is not informed but he is acting as a decision-maker, *e.g.* for the issue of new shares".<sup>6</sup> The result is that a 'specific' information as required cannot be the decision expected to be taken by someone who acts not as a service contracting party but as a shareholder. In the interpretation of Georgakopoulos the text of the provision is confined to '*service insiders*' and does not include '*participatory insiders*'.<sup>7</sup> According to the same commentator 'a share-holder having his own decision possibilities and perspectives does not benefit from information but from his own decision'.<sup>8</sup> Even in the case where the shareholder is an officer, employee or other 'service insider' and he has access to information about future



decisions of shareholders, it is a question of causality, argues Georgakopoulos, whether he benefits from the information or from his own decision. Furthermore, 'the other parties to a transaction cannot require him to abstain from benefiting from his own decisions as a shareholder'.<sup>9</sup> The main argument for the exclusion of the participatory insider from the Greek insider regulation along these lines of construction, before the adoption of PD 53/92, seemed to be that the perspective of the insider himself, *i.e.* his decision, is not known to the other contracting party in the transaction unless the insider undertakes to decide as expected. Only if such an obligation is not undertaken, does the benefit accrue from an uncertain perspective and not from inside information. Still, under that theory shareholders cannot use information referring to facts or decisions already existing, *e.g.* a resolution already taken concerning issue of new shares.

Livos<sup>10</sup> and Michalopoulos<sup>11</sup> consider shareholders of a significant percentage as potential insiders under paragraph 1 of Article 30 of Law 1806/1988 and their view is more convincing because of the terms used in the statute and the clear intention of the legislator to cover all persons participating in the management of the company or rendering any kind of services to the company, complying, thus, with the Directive. At this point, it should be noted that the EC Directive [Article 2(1)], as implemented by article 3(1) of PD 53/92, imposes on primary insiders (among them persons who possess inside information *by virtue of their holding in the capital of the issuer*) a rebuttable presumption of knowledge of the privileged information. Professor Hopt has suggested that Member States should introduce a less bureaucratic registration system for company insiders confined to major shareholders for example from 10 per cent up.<sup>12</sup>

The choice of the Greek law is that spouses or children of the above-described persons would not be covered except possibly as 'secondary insiders', since they do not 'render services' to the enterprise. The inclusion of spouses and children in the first category would prevent the infringement of the provision by these persons, combining a more immediate deterrent effect with easier proof of the act of trading.

*De facto* or *de jure* executives of a legal entity rendering services to the enterprise could be offenders within the meaning of the Law, although the Law does not include a specific provision similar to Article 2, paragraph 2 of the Directive, which specifies that when the insider is a legal person, the prohibition applies to natural persons who take part in the decision to carry out the transaction. Article 3(2) of the PD 53/92 does include a specific provision making it perfectly clear that in the case of legal persons the provision shall apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned. In this respect it should be stressed that under the Greek criminal law, a legal entity may not be prosecuted criminally; only its managers may be held criminally liable.

It has already been remarked that the requirement of 'obtaining a significant financial benefit' in the insiders objectives was done away with by PD 53/92. Under article 30 of the Law '*benefit*' can be a benefit for the insider himself or for a third party. Given that inside information is only that which can have a substantial influence on the price, the benefit must also be significant and almost invariably translated into a price difference.

According to the Law the responsibility of insiders is a double one:<sup>13</sup>

(a) Illegal benefits. Direct insiders are responsible if they benefit themselves from their own information.

(b) Illegal breach of confidence. Direct insiders are also responsible



when they let third parties benefit from their information. This is a responsibility for breach of confidence enabling someone else to benefit, and does not require benefit for the insider. The responsibility is independent from the reason of breach, economic or social. It may coincide, however, with the responsibility of the indirect insiders.

### *B. Secondary Insiders*

Secondary or indirect insiders are those who obtain information from a direct insider and use it in the knowledge of the nature of the information as 'confidential information' (art 30 para 2 of the Law). The provision of the Law is similar to Article 4 of the Directive and does not create a presumption of knowledge regarding the source from which such secondary insiders gain knowledge of inside information.<sup>14</sup> The method of obtaining the information is irrelevant and the knowledge of its confidentiality is necessary. Such persons who make use of inside information acquired in this manner are punishable by the same penalties as 'primary insiders'.

One important question is whether both the primary and secondary insiders are responsible for the use of the same information in the same transaction. The answer seems to be that there can be no double use of information in the same transaction. It is indeed provided that the use of the information by the primary or secondary insider can be made either by himself or through a third party (art 30 paras 1 and 2 of the Law). If the insiders use it through a third party, then this party is acting for them and there is no second use. If direct or indirect insiders obtain information but do not use it in buying or selling securities, then they do not commit insider trading, although they might have sold their information to indirect insiders, possibly constituting, thus, another sort of offence.<sup>15</sup>

It is rather difficult to ascertain the persons who belong to the category of secondary insiders: the spouse or the children of primary insiders, brokers or members of brokers companies (sociétés anonymes), banks holding shares in brokers S. As., journalists of financial press, investment analysts having the initiative to approach companies and to negotiate the possibilities of co-operation, public authorities exercising supervision on public companies (S. As), even maintenance contractors in the premises of the company or the driver of a member of the board of directors, can be secondary insiders. The unlimited possibilities of expansion of the provision (especially in the last two cases) should be faced with scepticism. As the distance between potential secondary insiders and the centre of decisions grows, the more impractical the implementation of the provision becomes. In addition, the difficulties of proof of the knowledge of the confidential nature of the information are aggravated.<sup>16</sup>

Finally, it should also be noted that both primary and secondary insiders can utilise the inside information either themselves or through other persons.<sup>17</sup>

The PD 53/92 uses the definition of the Directive on primary and secondary insiders. Primary insiders are *'holders of the office of director, shadow directors, shareholders or other persons who have privileged access to information because of their profession, employment or duties.'* Consequently, as the Greek legislation follows the Directive, it covers only indirectly the further transfer of inside information from a tippee to another third party. Article 5 of the PD 53/92 fashioned on Article 4 of the Directive prohibits trading by anyone on the basis of inside information when he knows that he is in possession of confidential information the direct or indirect source of which cannot be other than a primary insider. Unlike s 60(1) of the UK CJA 1993, under the Greek Law secondary



insider's *mens rea* is established only when he has actual knowledge that he is in possession of confidential information. However, reasonable cause that the source of information is a primary insider suffices to fulfil the second of the Article 5 requirements.<sup>18</sup>

## 2. Inside Information

Article 30 of the Law imposed sanctions against insiders who used 'confidential information' to purchase or sell securities listed on the stock exchange. The purpose of the relevant provision, as stated in the introductory report, was to ensure, to the extent possible, equality among investors. Paragraph 4 of Article 30 of the Law, obviously influenced by Community Law, was superseded by Article 2 (1st case) of the Presidential Decree 53/92 which sets out the cumulative combination of conditions determining the confidential nature of information:<sup>19</sup>

a) Confidential information is the information which is not made known to the public in any way. That is to say, it must not have been made known outside the company. Temporal precedence is attached to the privileged character of information. The concept of 'published information' of Article 30 created problems of interpretation. Was legal publication, as prescribed by the company statutes, required or should publication in the financial press be considered sufficient? The reference of Article 30 to '*any other ways*' of publication was broad enough to embrace any other way not specifically stipulated by statutes provided that the average investor had the possibility for timely assessment of the information.<sup>20</sup>

b) The information must be specific. It must not be mere assumption but must concern certain facts, positive or negative, apparently related to

the financial status of the company. Information, for example, on a forthcoming merger, bankruptcy, increase of the share capital, increase of dividends because of higher profits, the discovery of oil deposits etc. fall clearly within the scope of the definition of specific information.

c) The information must concern one or several issuers of transferable securities or one or several transferable securities admitted to trading on a market. A question could be posed in this case as to whether the information can concern a non-listed subsidiary company the performance of which has important consequences for the parent company.

d) The information could affect perceptibly the price of such securities if made known to the public. This last element of confidential information is the most substantial and is apparently related to the financial importance of the privileged information. The test for the price-sensitive nature of the information is neither the expert assessment that could be carried out by experienced (professional) institutional investors nor the simplistic estimate and the haphazard choice that could be made by a chance investor under the strain of speculation. The measure for assessing the significance of the effect on the price that the confidential information could have, should be sought in the ordinary course of stock-exchange transactions<sup>21</sup>, or to the perception of the average investor which must be "the point of reference and the centre of gravity of the sought protection".<sup>22</sup>

The cumulative combination of the above four conditions is required for characterising the information as confidential and for constituting the criminal act. One more element is self-evident: the test of the confidential character of the information must take temporal precedence over the time of confirmation of the information, *i.e.* the test must be made when the



order for purchase or sale was placed.<sup>23</sup> Considering the varying length of time between the characterisation of some information as confidential and its de-characterisation through publication, the importance of its timely testing cannot be overemphasised.

### 3. Presumption of Knowledge

The EC Directive imposes on primary insiders a *rebuttable*<sup>24</sup> *presumption of knowledge* of the privileged information. Michalopoulos has expressed the opinion that, according to Article 30 of Law 1806/1988, a presumption of knowledge of the confidential character of the information must exist for the persons having an organic or operational relation with the company, as long as the relevant decision, in its substance, belongs to the sphere of their duties. This view runs counter to a basic principle of Greek Criminal Law. As a general rule in the penal code the notion of '*presumption*' is never applicable to an offence committed intentionally or negligently. Moreover, in criminal proceedings no presumed or 'formal' truth exists and the search for the truth is made *ex officio*, it being the task of the public prosecutor to ascertain the true state of affairs. Consequently, the Law has not created a presumption of knowledge of inside information for any potential offender.<sup>25</sup>

### 4. Transferable Securities

The PD follows the Directive in the definition of the kinds of transferable securities covered and the markets the securities concerned must be negotiable in. Thus, the PD covers index contracts but remains silent as regards OTC contracts for differences, a source of major controversy in the UK following the Trafalgar House Affair. However,

given that derivatives contracts are not yet negotiable on the Athens Stock Exchange, this omission is not yet of material importance. The same applies for a recent amendment of the PD by article 51 of law 2533/1997 which extended the scope of transferable securities including *units of investment funds* admitted to trading on a market. No such units have been listed yet on a Greek market. Consequently, the provision is only applicable for units traded on overseas markets qualifying under the provisions. The Greek adaptation of the Directive's "*market which is regulated and supervised by authorities recognised by public bodies, operates regularly and is accessible directly or indirectly to the public*", gives the wrong impression that a cumulative combination of conditions is required by article 2 of the PD: (a) the securities must be admitted to trading on a market operating under certain rules, (b) the market must operate within the E.U., (c) the market must be supervised by a publicly recognised body, and (c) must be directly or indirectly open to the public. Fortunately, in case of doubt the original text of the Directive prevails. Moreover, the *direct effect* of EU Directives is increasingly recognised by recent cases and jurisprudence as it has already been stressed in previous chapters.

The PD does not apply to transactions effected by a public authority in pursuit of monetary or public debt management policies. Also, Article 6 follows Article 2(3) of the Directive, providing by implication that transactions in transferable securities effected through a professional intermediary outside a regulated market are not caught.

## **5. The Insider Trading Offence**

The prohibited activity of Article 30 of the Law consists of the use of confidential information by an insider, to purchase or sell, himself or



through a third person, securities listed on a stock exchange of a given enterprise, with the purpose of 'obtaining significant benefits for himself or a third party or causing significant loss to a third party.'<sup>26</sup>

The PD, following the Directive, did not adopt the *benefit* requirement, and extended the scope of the offence to *participatory* insiders.

Under article 30 of the Law the following conditions must be fulfilled:

#### *A. Personal Conditions*

The liability depends on the quality of the person as a direct or indirect insider. The quality of the insider has been examined above. This personal quality consists of the existence of confidential knowledge acquired either personally (by the direct insider) or from a direct insider (by the indirect insider).. Nobody is responsible for obtaining or having information *per se*, even if this information is confidential. The nature of (confidential) information has already been considered. Referring to the sense of information, there is no difference between direct and indirect insiders.<sup>27</sup>

#### *B. Objective Conditions*

Objective conditions consist of the act, which if executed by a person presenting the personal conditions, is the ground for his punishment. This act is the use of the information in buying or selling securities by the insider. According to the apposite interpretation of Professor Georgakopoulos 'using information in buying or selling means a causality between the information and the transactions decision (buying or selling).'<sup>28</sup> Consequently, if a person has knowledge of the information, but acts independently, which is not impossible, a causality does not exist. Moreover, causality does not exist if the decision was taken before the knowledge, e.g. by fixing an investment and portfolio management plan,

or if the decision was taken in knowledge of the information but not as a result thereof, e.g. by taking into consideration other aspects of the security. By a bigger transaction there can be a use of information concerning the part of the transaction, which would not take place if the information was available, but not the rest.<sup>29</sup>

### *C. Finality Conditions*

The intent 'to obtain a significant financial benefit for himself or a third party or to cause a significant loss to a third party'<sup>30</sup>, is also required by the provision in order to constitute the offence which is different from the mere intention to use the information. The user may have any of the following three objectives: (i) Significant benefit for himself, or (ii) Significant benefit for a third party, or (iii) Significant damage to a third party, and perhaps eventually to the company itself.

The determination of the significance of the gain or loss is left in specific instance to the courts.<sup>31</sup> The adoption of the term '*significant*' gave rise to strictures by many members of the Parliament. It has been criticised as being vague and legally unjustified. The size of the profit expected, in this view, does not create the punishable character of the action. In other words, the *raison d'être* of the provision is to 'sanction the intentional exploitation of confidential information possessed by an insider',<sup>32</sup> regardless of the final outcome of the insider's act.

The finality condition, according to the theory of Greek Criminal Law is part of the '*subjective foundation*' of the offence.<sup>33</sup> That is, the offender does not have to achieve his purpose. In this particular case, it does not appear material whether significant benefit or loss has been actually realised, i.e. the user can fail in his objective. It is however sufficient as far as his responsibility goes that he had the intention to benefit himself or damage others when using the information.



It has been correctly remarked that the attainment of financial gain can be indicative for the *in concreto* calculation of the fine. It has also been supported that the achievement of financial profit (or damage to a third person), after the investigation of the crime, can influence starting or continuing criminal proceedings.<sup>34</sup>

#### *D. Aggravating Circumstances*

The third paragraph of Article 30 of Law 1806/1988 defines as an aggravating factor of the offence the commission of the act 'by persons working for limited stock exchange corporations in the equity of which participate banks, or for a bank that is a shareholder in such Corporation'. In this paragraph no stricter sanctions are provided for, neither have the conditions that constitute the basic act changed and, therefore, no special form of the basic offence is created. Consequently, the role of the aggravating factor is confined to the judicial determination of the sentence (or fine) according to the general principles of Criminal Law (Article 79 of the Penal Code).<sup>35</sup>

This provision was seemingly added at the request of certain Ministers who expressed the fear that such participation of banks in the equity of stock exchange companies could become a special source of confidential information.<sup>36</sup> During the parliamentary debate it was made clear that the provision should cover persons rendering services to or for a bank. The problem is that the wording of the statute, as Lambadarios correctly points out, fails to convey this idea.<sup>37</sup> If the person concerned does not render services simultaneously to or for the enterprise or issuer of the stock exchange securities, the prerequisite of paragraphs 1 and 2 is not met. In that case the offender is a person who renders services to the stock exchange corporation or the bank and not to the enterprise the securities of which are the object of the purchase as provided in Article 30.

The prerequisite of shareholding of banks has been criticised as unjustified on the grounds that it covers only stock exchange companies in which banks are shareholders, and banks, shareholders of such companies, whereas it should be sufficient that the offender is an employee of the stock exchange company or the bank with which the enterprise collaborates, whether or not the bank is a shareholder.

*E. Defences (under article 3 of the PD 53/92)*

According to Article 3 of the PD a valid defence is established if it is proved that the transaction was done otherwise than with a view to making a profit or avoiding a loss by the use of inside information. A defence is also established when an insider can prove that he had reasonable grounds to believe that the information had been disclosed widely enough to be perceived as public, ensuring that others dealing in the same security would not be prejudiced by not having privileged access to that information.

This is a somewhat tentative interpretation of the PD wording, since no guidance is given by it as to when inside information becomes public - in contrast with s 58 of the CJA 1993. In addition, it remains unclear whether other reasonable defences like those included in s 53(1)(c) and s 53 (2)(c) of the UK CJA 1993 (that the defendant has a defence if he can prove that he would have dealt in the security or encouraged the deal in any case) would constitute a valid defence under Greek law. There is no exemption in Greek law in the Directive for professional dealers and the same applies to equity issues *stabilisation* exempted under Sch 1 para 2 of the UK CJA 1993.



### III. Control of Insider Trading - Supervision of Transactions

The Greek Insider Trading Law should be examined in the context of the 1988 reform in Stock Exchange Law. As Georgakopoulos has stressed, the undisclosed but clear point of departure of the 1988 reform is state interference in the administration of the Athens Stock Exchange.<sup>38</sup> It is indicative that three members of the board of the Stock Exchange are not appointed by brokers but are proposed by them and appointed by the minister. Brokerage companies are given three seats on the board independently from their number, since these companies are expected to be subsidiaries of the banks. Three other members are proposed by employees, investment companies and companies having securities listed on the stock exchange. The minister is given the right to appoint the seventh director. The post of the president of the stock exchange is unlikely to be held by a broker because the latter would have to suspend his brokerage activities.<sup>39</sup> For reasons of transparency Articles 27 and 28 have introduced the rule of written evidence of all orders. This step facilitates inspection by officers of the Ministry of National Economy and emphasises the responsibilities of insiders.

The designated authority that deals with the implementation of the prohibitions of the PD 53/92 (as required by Art 8 of the Directive) is the Capital Market Commission under Art 8 of the PD, which must be assisted in the discharge of its duties by the Ministry of National Economy Division for the supervision of the Athens Stock Exchange.

#### 1. Civil Law Consequences

The Law does not make the relevant transaction either *void* or *voidable*. No other civil consequences are prescribed for insider trading.<sup>40</sup> The person who suffered damages from the illegal action of the offender

has, nevertheless, the possibility to claim compensation under the general clause of the Civil Code. Under Article 914 of the Civil Code 'a person who through his fault<sup>41</sup> has caused, in a manner contrary to the law, prejudice to another shall be liable for compensation'.<sup>42</sup> It should be stressed that under Greek Law, as under the majority of Civil Law systems, treating insider dealing as a matter of civil liability is not mutually exclusive with the initiation of criminal proceedings as well as with treating the act as a criminal offence. The person or legal entity that have suffered loss because of the act of the insider can be compensated therefor under the general clauses of the Civil Code, participating in the criminal trial as plaintiffs for the civil claim.<sup>43</sup> On the other hand the conviction of the offender is not a necessary precondition for the awarding of damages. A civil action without any criminal proceedings taking place can be raised by the person who suffered damages.

This solution is undeniably more realistic than the solution adopted by the current British legislation<sup>44</sup> and is more likely to provide adequate deterrent to potential insiders. The pecuniary penalties imposed by the Greek Criminal Law (No 1806/1988) are, nevertheless, too low.

Article 11 of the PD 53/92 provides that apart from the criminal sanctions provided for in Art 30 para 1 and 3 of Law 1806/1988, the Capital Market Commission can impose on violators of the relevant prohibitions fines ranging from 10.000.000 drs to 1.000.000.000 drs, or fines to five times the insider's profits.

## **2. Prosecution**

In the absence of specific rules regarding the commencement of criminal prosecution against insiders, the general principles of the Code of Criminal Procedure will be applied. Articles 36 and 52 of the latter state



that criminal prosecution commences, as a general rule, *ex officio* following a report, a charge, or other information that a punishable act has taken place, except in specific cases where a formal complaint of the person against whom the offence has been perpetrated is required by law. Prosecution of insider dealing may start *ex officio*, at the request of the Board of Directors of the Stock Exchange or the competent authorities of the Ministry of National Economy. The Department of Stock Exchanges and the Department of Capital Market that have been created by Article 24 of Law 1806/1988 and operate under the aegis of the Ministry of National Economy can also start prosecution. Finally, prosecution can start 'pursuant to a denunciation by any citizen'<sup>45</sup> but, in all cases, it is carried out exclusively by the public prosecutor.

### 3. Sanctions

The Greek legislator has chosen criminal sanctions and administrative penalties for the insider trading offence. The offenders are threatened by, at least, three months imprisonment and pecuniary penalty. For the determination of sentences or fines the Law refers to the general principles of Criminal Law. The issue of the appropriate penalties caused controversy in the Parliament where the opinion has been expressed that the penalties provided are too lenient.<sup>46</sup> According to the general provisions of the Penal Code (Articles 51 and 53) imprisonment can be up to five years, while the pecuniary penalties range from Drch. 2,000 to Drch. 1,000,000. The possible imprisonment sentence can be considered as sufficient deterrent to potential offenders, whereas the maximum amount of the fine is definitely too low and, thus, fails in its deterrent objective. If the measure of the fine were linked to the amount of the illegal profit that was made or the loss that was avoided or the

damage that was caused, as an equal or a multiple of this amount, the objective of the provision would be better served.

The Presidential Decree 53/92 (Article 11) increased the pecuniary penalties that the Department of Capital Market can impose on insiders. The penalties range from 10,000,000 drachmas minimum to 1,000,000,000 drachmas maximum or to the illegal profits multiplied by five. It can hardly be denied that the amendment has given additional deterrent effect to the insider legislation.

#### **IV. Major Acquisitions Disclosure (Insider's Disclosure, art 29 of Law No 1806/1988 and Presidential Decree 51/1992)**

The disclosure of major acquisitions results in the disclosure of insiders and belongs, therefore, to the insider dealing regulations. Major acquisitions have to be brought to the attention of the Stock Exchange Board of Directors prior to registration. Anyone interested in the registration and specifically the transferee can notify the board. The company has to proceed to registration upon evidence of such notification. The stock exchange does not have the authority to stop the registration or to make it subject to any conditions. If the acquisition was concluded as a compensatory transaction, notification of the stock exchange is not necessary because such transactions can only be effected by permission of the Board of Directors of the stock exchange and, therefore, are known to it. The absence of notification does not render void the registration of the transfer by the company, since no such sanction is provided by the Law. The interpretation that the registration is not void is supported by the fact that the acquisition is mentioned in the provision as effected before registration.<sup>47</sup> The company has no right to deny registration if the latter is



requested by a shareholder who is a company, possibly controlled by another shareholder. Any objections of the company effecting the registration have to be proved.

The stock exchange has to inform the public about acquisitions. The way of publication will be determined by a decision of the supervising minister.

*Major acquisitions* are defined by the Law as acquisitions of nominative shares listed on the stock exchange that exceed or bring an existing participation over 10, 25, 33.3, 50 and 66.6% of the voting or non-voting share capital of the company. *Nominative* shares are mainly the shares of banks, or insurance companies, or the shares of any company if they are not fully paid up. The legal reason for the acquisition is irrelevant.<sup>48</sup> It can be purchase, barter, subscription, inheritance or merger of parent companies. Transfers of major participations to new shareholders fall in the scope of major acquisition. The notion of major acquisition is restricted to nominative shares because it would be enormously difficult to detect such matters involving bearer shares.

The concept of acquisition of shares comprises both *ownership* and *control* of shares. 'Control' is interpreted as the majority percentage in a company.<sup>49</sup> Consequently, the term major acquisitions affects both shares owned by a shareholder and shares owned by companies in which there is a majority shareholder. Georgakopoulos remarks with felicity that 'the most customary majority shareholder in the Athens Stock Exchange is the Greek State and the state companies, mainly state banks and the holding company for companies under reorganisation'.<sup>50</sup> As a result, the aforementioned state companies are the main insiders affected by this provision.

According to Article 29 paragraph 2 which deals with *existing*

*participations*, any shareholder of nominative shares listed on the stock exchange, holding or controlling 10% of the share capital of a company, at the time of enforcement of the Law, has to inform the stock exchange about any acquisition, even of one share.

When transfers of nominative shares listed on the Stock Exchange are effected they are registered through a broker's deed on the reverse of the share plus an inscription in the roll of the Stock Exchange. Registration in the company books is effected after and according to the notary's or broker's deed. The broker's deed is the content and the condition of the notification to the Stock Exchange Board of Directors.

In the recent amendments to Law 1969/1991 on the Stock Exchange and the competence of the Capital Market Committee special provisions on market manipulation and '*market making*' that constitutes dissemination of false information likely to influence the price of securities, were included.<sup>51</sup>

## **V. Criminal Law Provisions outside the scope of Law 1806/1988 and PD 53/1992**

Before the enactment of the Greek Insider Trading Law some provisions of the criminal legislation could be applied to certain insiders. Some of these provisions could play at present an ancillary role.

### **a) Provisions of the Penal Code**

Article 191 of the Penal Code (on the disturbance of state investment policy) provides that 'whoever spreads false news or rumours with a view to disturbing the policy of financial development followed by the state for the encouragement of domestic private investments or the attraction of foreign capital, is punished'. This is a crime against public order and, specifically, the state regulation of investment policy.



The provisions aiming to secure confidentiality (252 Penal Code) or, especially, professional confidentiality (371 Penal Code) are conceptually related to Law 1806/1988. On the one hand they cover a wider scope of cases of breach of confidentiality, on the other they are narrower regarding the potential perpetrators (e.g. only auditors of companies, barristers, notaries or legal advisors who have access to secret records because of their profession or position in the company could be caught by the provision).<sup>52</sup>

According to Article 406 of the Penal Code on profiteering, 'whoever exploits, out of greed, the inexperience or mental weakness of another person, misleading him in stock exchange speculative transactions, outside of his area of business activities, which are grossly disproportionate to his fortune and which, because of this fact, may bring or accelerate his financial ruin, is punishable by imprisonment of up to two years'.

Articles 386 and 389 of the same Code provide that:

*(i) Whoever, with the intent of deriving for himself or for another person an illegal financial benefit, damages property belonging to another, persuading such person to act, omit or tolerate (an act or omission), by an intentional statement of false acts as true or by the illicit concealment or passing over in silence of true facts, is punished by imprisonment for at least three months and if the damage caused is considerable, by imprisonment for at least two years. Imprisonment for up to ten years is ordered if (a) the guilty person commits fraudulent acts by profession or habit, or (b) the circumstances under which the act was committed evidence the dangerous personality of the guilty person.*

*(ii) Whoever intentionally illegally damages property belonging to another, persuading such person to act, omit or tolerate (an act or omission) by intentional representation of false acts as true or by illicit concealment or passing over in silence of true facts, is punishable by imprisonment for up to two years or by pecuniary*

*penalty.*

Lastly, the crime of breach of confidence (390 Penal Code) could be applicable if confidential information is perceived as an element of financial value which is meant to be used for the achievement of the objectives of the company, yet it is being exploited by, and for the benefit of, directors.<sup>53</sup>

b) Provisions in Company and Stock Market Law statutes

According to Article 56 of the law on public limited companies (*sociétés anonymes*) 2190/1920, any founder, director or manager of a company who, in order to induce subscriptions to shares, founder's shares or bonds of such company, or to influence the Stock Exchange quotations thereof, knowingly makes false declarations to the public through publications or written statements concerning: (i) the subscription to, and payment of, the share capital, the issue price of shares, founder's shares or bonds, the balance sheet or the distribution of dividends, (ii) the names of shareholders participating or about to participate in the company under any title whatsoever, (iii) any other event which bears influence on the affairs of the company and which is intended to entrap the public, is punished by imprisonment and a fine not exceeding Drch. 80,000 or to either of these penalties.<sup>54</sup>

Under Article 34 of Law 3632/1928 on securities markets, (a) anyone who, with the purpose of obtaining an illegal<sup>55</sup> benefit uses, with full knowledge that he is doing so, means that may mislead the public in order to influence the stock exchange prices or (b) makes inaccurate statements through the newspapers or publications, with the aim of obtaining public subscription, purchase or sale of securities listed on the stock exchange, commits a punishable offence. The same rule is applicable to anyone who publishes stock exchange bulletins contrary to the provisions of the law



and stock exchange regulations or who puts into circulation copies of such bulletin, with the purpose of obtaining illegal benefits.

The more recent Law 1969/1991 published in October 1991, concerning the Stock Exchange, grants to the Capital Market Committee the responsibility of supervising the smooth operation of the Stock Exchange and of safeguarding compliance with securities legislation. It is also provided that both the Board of Directors of the Stock Exchange and the Capital Market Committee may impose the following penalties upon brokers whose behaviour is contrary to the *bonos mores* and commercial usages: (a) reprimand; (b) prohibition of effecting stock exchange transactions for up to 15 business days; (c) publication of the offender's name on the board of the Stock Exchange; or (d) financial penalties of up to Drch. 100,000,000 (as amended by article 96 of law 2533/1997).

Imprisonment and fine up to Drch. 100,000,000 are provided against members of the Stock Exchange who, during a session of the Stock Exchange, use *misleading or deceptive methods* and means with the intent to generate, frustrate or otherwise influence a transaction concerning a specific security in order to obtain an illegal profit for themselves or a third party. A penalty up to Drch. 500,000,000 (as amended by article 96 of law 2533/1997) is threatened by Article 72 of the law 1969/91 against any person who disseminates false information likely to influence the price of securities listed on the Stock Exchange. These penalties may also be imposed on members of the Board of listed companies and their financial advisers as well as on sponsors of issuers of securities.<sup>56</sup>

## VI. Conflicts of Laws issues

### 1. Jurisdiction

Article 5 of the Greek Penal Code adopts the *lex loci delicti*, i.e. for illegal acts committed in Greece, Greek law is applicable regardless of the nationality of the perpetrator. In addition, according to Article 6, Greek criminal laws are applicable to Greek nationals for felonies or misdemeanours committed abroad, if they are also punishable under the laws of the country where the act has been committed.<sup>57</sup> Under Article 7 of the same Code, Greek law applies to aliens for offences against Greek nationals committed abroad.

As Lambadarios remarked, Article 30 of Law 1806/1988 does not state specifically that it applies only to transactions on the Greek Stock Exchange and it would be, therefore, theoretically possible to consider the provisions of Article 30 applicable whenever an offence has been committed abroad by a Greek citizen, as well as if the offence were committed by a foreigner against a Greek citizen. The same commentator claims, however, 'that the legislature had in mind Greek stock exchange transactions, since the provisions of Article 30 have been included in the legislation reorganising the Greek Stock Exchange, and that acts committed abroad will, in principle, be governed by the legislation of the country in which insider trading took place'.<sup>58</sup> Nevertheless, the Community legislation seems to legitimise the plurality (or, perhaps hierarchy) of competences (*cumul de compétences*) giving to Member States the possibility to maintain the already existing rules.<sup>59</sup>

The PD 53/92 covers illegal actions undertaken within the Greek territory (article 6), apparently adopting the *lex loci delicti*. Along the lines of the Directive, a specific presumption is established that a transaction is carried out within the Greek territory if it is carried out on the Athens



Stock Exchange. Illegal transactions on securities traded on foreign markets (especially markets of EU Member States) are also caught, provided they are carried out in Greece, despite the problematic wording of article 2. *Any* person dealing in Greece, whether a Greek national or not, falls within the scope of the provision. The transactions must be in transferable securities admitted to trading on an organised market. A list of organised markets is compiled on a yearly basis by the Capital Market Commission, pursuant to the Investment Services Directive, in order to serve the needs of Investment Firms. If the transferable securities concerned are traded on an *organised* market of that list, the condition set by PD 53/92 will, in all probability, be fulfilled.

## 2. Enforcement and Judicial Assistance

Financial crime is largely a cross-border phenomenon and the 'traditional reluctance of governments to co-operate in law enforcement matters has in the past been a problem' which necessitated international treaties and informal arrangements between regulators.<sup>60</sup> Article 8 of Directive 89/592/EEC on insider dealing provides for the creation of the competent *monitoring authorities* with full *supervisory* and *investigatory* powers that are necessary for the implementation of the Directive. The competent authorities of Member States shall co-operate with each other whenever necessary for the purpose of carrying out their duties, making use of the powers given to them. The latter provision of the Directive is reiterated by article 10 of PD 53/92.

At this stage there is no special legislation in Greece regulating issues of intereuropean and international co-operation on cases of insider dealing. The Capital Market Commission has taken some steps to the right direction by means of a number of Memoranda of Understanding signed

with competent authorities of other states. These MOUs outline the framework of mutual assistance, co-operation and exchange of information that may be related to insider dealing.

At present the Greek Penal Code comprises stipulations on judicial assistance. There are special provisions (a) on requests of Greek judicial authorities to foreign authorities for the hearing of witnesses and persons accused of an offence and the carrying out of inspections and expert consultations as well as the attachment of exhibits, and (b) on requests of foreign judicial authorities for Greek investigating authorities to conduct investigative actions. The European convention for mutual assistance on criminal cases has been ratified by the law decree 4218/1961. The Penal Code also regulates in detail matters of extradition. It should be noted that Greece has signed several bilateral treaties on extradition and that the European Convention on Extradition of December 13, 1957 has been ratified by the Law 4165/1961.

### **3, Enforcement and the November 1996 crisis.**

At the heart of the November crisis, which took the financial world by surprise when regulators closed down the Athens Stock Exchange for three working days, was a Brokerage Firm member of the ASE, Delta Brokers and a 'long-standing backlog in the clearing of matched orders in the clearing house and the delivery of securities and payments to those entitled to them'.<sup>61</sup> Delta Brokers had effected enormous purchases of the shares of two listed companies, Magrizos and Parnassos, acting on the orders of clients or as principal with the clear view to manipulating the stocks' price. Short sales, '*wash sales*' and matched orders were among the most frequent techniques used. Prearranged transactions at agreed prices, manipulation of supply and demand, '*attempting to recycle liquidity from*



*sales into purchases of the same shares in an ever widening cycle of transaction growth and financial exposure*’,<sup>62</sup> all these manipulative practices are clearly prohibited. The Capital Market Commission held that the insider dealing legislation had been violated (both art. 30 of Law 1806/88 and PD 53/92) because insiders acted on information they had produced themselves by creating a misleading impression on the price and the trading volume of the above security, and imposed pecuniary penalties on the violators on the basis of this construction.<sup>63</sup> At the same time the Commission passed on the relative file to the competent public prosecutor in Athens.

Criminal courts have not yet decided on the issue. It remains unclear, therefore, whether they will follow the interpretation of the Commission in criminal proceedings. It should be stressed, however, that in their recent decisions<sup>64</sup> Administrative Courts of First Instance upheld the decision of the Capital Market Commission on the pecuniary penalties and adopted the somewhat extreme interpretation the latter gave to *‘participatory insiders’* and confidential information. The decisions of the Administrative Courts have been criticised as wrongfully bringing market *fraud* under insider dealing. According to one commentator the fraudulent intervention in the price or the trade volume of securities may amount to fraud but it is rather unlikely that it amounts to abuse of confidential information (*i.e.* insider dealing).<sup>65</sup> These strictures seem to ignore the possibility afforded by EU Directives: According to article 6 of the Insider Dealing Directive ‘each Member State *may* adopt provisions more stringent than those laid down by this Directive or additional provisions, provided that such provisions are applied generally’. On the other hand, these criticisms constitute an apparent effort to interpret the Greek legislation “*in the light*” of its obviously narrower in scope German

counterpart whereby fraudulent transactions of price manipulation are not caught by the prohibition of insider dealing.<sup>66</sup>

## VII. Appraisal

The existing *duality* of the Greek Insider Dealing legislation (art 30 Law 1806/88 *versus* PD 53/92) can be both a blessing and a curse. A curse because of its complexity and the additional interpretation difficulties it entails. A blessing because of the additional flexibility, especially regarding service and participatory insiders, it affords to the supervisory authorities and courts in their effort to '*promote compliance with those measures*'.<sup>67</sup>

The difficulties of assessment, assimilation and exploitation of special economic information by the average investor is closely connected in the Greek Law, with the lack of regulation on investment consulting. The fact is that there are special provisions for the functioning of institutional investors (investment companies and mutual funds of law decree 608/70) but the regulation of mediatory, consulting, and managerial professions is ignored. The aforementioned activities are exercised incidentally and as a monopoly by banks, stock-brokers and brokerage companies.<sup>68</sup> The latter can only give advice to their clients based on quick evaluation of *public* information and correct analysis. Their duty to offer *timely* advice does not include the use of confidential information.

The underlying philosophy of Article 30 (Law 1806/88) and the Presidential Decree 53/92 is the restoration of the principle of equality of opportunities among investors. The well-aimed exploitation of public information after expert assessment of all indications and investment advice is not the behaviour outlawed by the provision. The exploitation of the knowledge or possession of confidential, privileged information, not



made public, with full knowledge of the source and the nature of the information, constitutes the punishable act. The enactment of the Greek legislation, as well as the insider dealing legislation in the rest of the Member States, has been in temporal conjuncture with the increase in corporate concentrations *e.g.* take-overs, mergers. The latter being critical decisions for the future of enterprises and for the fluctuation of the price of the relative securities, offer an additional lure of profiteering.<sup>69</sup>

While it is self-evident that no absolute protection against the practice of insider dealing can be secured, the efficiency of the enacted statute remains to be tested through judicial implementation and jurisprudential elaboration. The basic questions that will undoubtedly be posed are: (a) when some confidential information which is known to a certain circle of *initiated* persons becomes the possession of investors as a whole.<sup>70</sup> Given that the illegal conduct must be judged at the time the order for the transaction was placed, in the case of multiple successive orders the problem is to discern which transactions resulted from the exploitation of inside information, which were dictated by an expert assessment of indications, and, finally, which were based on public information; (b) if 'the intent to obtain a significant financial benefit or to cause a significant loss to a third party' will be considered by jurisprudence as an aggravating circumstance after the enactment of PD 53/92 or a *conditio sine qua non* for the constitution of the art. 30 offence, thus, creating additional problems for the enforcement of the Law; (c) What means of proof of the knowledge of the confidential character of the information and its source will be approved; (d) How will the notions of '*significant financial benefit*' and '*significant loss*' be interpreted since these terms constitute '*interlocutory*' conditions for the commencement or continuation of prosecution.

The adoption of the provision is in conformity with the policy of the European Community for the creation of an internal market<sup>71</sup> on which Directive 89/592 was founded. The Greek insider dealing legislation is destined to make all persons involved in stock-market transactions sensitive about an abusive practice. The Greek Stock Exchange has come to flourish rather recently and its overburdening with repressive measures has been criticised as premature and excessive in comparison with the 'shallowness' of the market. On the other hand, in still unsophisticated markets the ways of violation of elementary principles can be even more primitive.

From the point of view of civil law the contract of sale of securities where one of the contracting parts commits insider dealing is a valid and legal contract effected through the mechanism of the stock exchange. It has already been stressed<sup>72</sup> that in the absence of any special provision the transaction is neither *void* nor *voidable*. The solution chosen by the Greek law is justified by the nature of the transaction. The contracts are concluded in an impersonal way according to the rules of the stock market in the sense they have been standardised and they concern standardised objects (securities). The prices are formed by market forces and mainly the law of supply and demand. It is the duty of the legal entity to disclose and publish information. The person who enters into a transaction does not have any such duty in that particular transaction. Along these lines no appeal can be made against the validity of the contract nor can contractual responsibility be sought. On the contrary, an *action in tort* based on the general clause of the Civil Code (Article 914) is possible, as has already been mentioned. What is most important is that the civil action can be tried in parallel with the criminal case and by the same (Penal) court.

The solution of law regarding the validity of the contract of sale of



securities burdened with insider dealing has been related to the theory that insider dealing is an offence without an easily identifiable victim, when it does not damage specifically some participant to the stock market.<sup>73</sup> This theory has been questioned and it has been argued that insider dealing may damage investors in general. Moreover, the fact that insider dealing may be a '*victimless crime*' does not eliminate the punishable character of the act.<sup>74</sup> On the contrary, it is rather clear that the act of insider dealing shakes investor confidence in the stock exchange<sup>75</sup> with all market-distortive repercussions.

The above comments lead to the following conclusions: Firstly, the centre of gravity of insider dealing legislation should be shifted from the control of contractual equilibrium between the principal contractual elements (e.g. offer, acceptance, consideration) to the control of extra-contractual elements that dictate the exact contents of the contract. The control should aim at securing the trustworthiness of market participants and the timely utilisation of confidential information for investors as a whole. Secondly, the strengthening of the deterrent effect of the pecuniary penalties of Article 30 (Law 1806/88) and PD 53/92 partly achieved the connection of the fine with the amount of the profit that was attained or the loss that was caused but there is still room for improvement. Lastly, the collective representation of investors is imperative for both the safeguarding of their financial interests and the vindication of their right of commensurate participation to the market. Indeed, investors are the 'direct receivers' of the *virtuous* conduct of the initiated, exactly as is the company *vis-à-vis* company directors and an unsuspected contracting party *vis-à-vis* the opposite contracting party. The upgrading of the role of investors organisations in the preparation and implementation of securities legislation is particularly important. In this view, what is sought

beyond mere deterrence is the co-operation and the allocation of responsibilities between 'victimisers' and 'victims' according to the international tendency in competition, consumer and labour law, which favours the conclusions of collective agreements or the working out of *deontology* rules between the representatives of financial sectors with conflicting interests.<sup>76</sup>

## NOTES

<sup>1</sup> L. Georgakopoulos, *The law of companies III* (Athens 1974, in Greek), p. 329 n. 584

<sup>2</sup> D. Lambadarios, "GREECE", *Insider Trading: The Laws of Europe, The United States and Japan*, Edited by Em. Gaillard, KLUWER 1992, p. 94

<sup>3</sup> Eva Lomincka, 'The New Insider Dealing Provisions', *Business Law Review*, 173, (1994), pp 184-88

<sup>4</sup> N. Livos, "Illegal exploitation by an insider of an enterprise's secrets", *Nomikon Vima*, Vol. 38/1990, at p. 56

<sup>5</sup> Lambadarios, *op. cit.*, at p. 94

<sup>6</sup> L. N. Georgakopoulos, "The Greek Insider Law", *European Insider Dealing - Law and Practice*, editors: Klaus Hopt & Eddy Wymeersch, KLUWER 1991, p. 178

<sup>7</sup> *idem*

<sup>8</sup> *idem*

<sup>9</sup> *idem*

<sup>10</sup> Livos, *op. cit.*, p. 56

<sup>11</sup> G. N. Michalopoulos, *Abuse of confidential information in the stock-exchange, insider trading under Article 30 of Law 1806/1988*, Sakkoulas eds, Athens 1991, (in Greek), pp. 51-52

<sup>12</sup> Klaus Hopt, "The European Insider Dealing Directive", *Common Market Law Review*, 27:51-82 (1990), p. 63

<sup>13</sup> L. N. Georgakopoulos, "The Greek Insider Law", *European Insider Dealing - Law and Practice*, editors: Klaus Hopt & Eddy Wymeersch, KLUWER 1991, p. 179

<sup>14</sup> Lambadarios, *op. cit.*, at p. 94 interprets the last sentence of Article 4 of the Directive as creating a presumption of knowledge "regarding the source from which such secondary



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insiders gain knowledge of inside information." This interpretation does not seem correct. As it will be shown later in this work the notion of '*presumption*' is not applicable to the Greek (or Continental in general) Criminal Law.

<sup>15</sup> Georgakopoulos, *op. cit.*, p. 179

<sup>16</sup> Michalopoulos, *op. cit.*, at p. 45

<sup>17</sup> Paragraphs 1 & 2, Article 30, Law 1806/1988

<sup>18</sup> Avgouleas Emilios, "The Implementation of the Insider Dealing Directive in Greece", *European Financial Services Law*, April 1997, p. 131

<sup>19</sup> G. N. Michalopoulos, "*Abuse of confidential information in the stock-exchange, insider trading under Article 30 of Law 1806/1988*", Sakkoulas eds, Athens 1991, (in Greek), pp. 51-52

<sup>20</sup> *idem* at p. 52

<sup>21</sup> N. Livos, *op. cit.*, at p. 58

<sup>22</sup> Michalopoulos, *op. cit.*, at p. 54

<sup>23</sup> *idem*

<sup>24</sup> The French ordonnance of 28 September 1967 imposes on company insiders an irrebuttable presumption of knowledge of the facts. In other words these persons cannot prove their ignorance of the information. The best view concerning the Directive is that it merely imposes on all primary insiders a rebuttable presumption. See: E. Gaillard & I. Pingel, "Les opérations d'initiés dans la Communauté économique européenne", *Revue Trim. Dr. Europ.*, avr.-juin 1990, pp. 329-355, at p. 337

<sup>25</sup> Lambadarios, *op. cit.*, at p. 95

<sup>26</sup> Article 30, paragraph 1 of Law 1806/1988

<sup>27</sup> Georgakopoulos, *supra* note 6, at p. 179

<sup>28</sup> *idem*

<sup>29</sup> *idem*

<sup>30</sup> Article 30, paragraph 1 of Law 1806/1988

<sup>31</sup> Lambadarios, *op. cit.*, at p. 96

<sup>32</sup> *idem*

<sup>33</sup> Livos, *op. cit.*, at p. 58

<sup>34</sup> Michalopoulos, *op. cit.*, at p. 57

<sup>35</sup> Livos, *supra* note 3, at p. 57

<sup>36</sup> Lambadarios, *op. cit.*, at p. 98

<sup>37</sup> *idem*

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<sup>38</sup> Georgakopoulos, *supra* note 6, at p. 180

<sup>39</sup> *idem*

<sup>40</sup> according to the general clause of the Civil Code [ ] the transaction could be declared void or voidable if it were characterized as contravening *bonos mores*.

<sup>41</sup> the existence of *fault* is presumed in all cases of breach of penal or civil law.

<sup>42</sup> Lambadarios, *op. cit.*, at p. 97

<sup>43</sup> in Greek: "*Politiki Agogi*"

<sup>44</sup> see following chapter

<sup>45</sup> Lambadarios, *op. cit.*, at p. 97

<sup>46</sup> *idem*

<sup>47</sup> Georgakopoulos, *supra* note 6, at p. 181

<sup>48</sup> Georgakopoulos, *supra* note 6, at p. 180

<sup>49</sup> Georgakopoulos, *supra* note 6, at p. 5

<sup>50</sup> *idem*

<sup>51</sup> Newspaper: *To Vima*, 25/4/1993, at p. Δ29

<sup>52</sup> Michalopoulos, *op. cit.*, at p. 62

<sup>53</sup> Michalopoulos, *op. cit.*, at p. 62

<sup>54</sup> Lambadarios, *op. cit.* at p. 99

<sup>55</sup> i.e. in breach of any penal, administrative, or civil law provision

<sup>56</sup> Lambadarios, *op. cit.* at p. 100

<sup>57</sup> *idem*

<sup>58</sup> *idem*

<sup>59</sup> E. Gaillard & I. Pingel, "Les opérations d'initiés dans la Communauté économique européenne", *Revue Trim. Dr. Europ.* 26(2) avr.-juin 1990, pp. 348

<sup>60</sup> Alastair Brown, "*Insider Dealing: Papers presented at a seminar, Edinburgh, 27 August 1993*", Edited by H. L. MacQueen, The David Hume Institute, Hume Occasional Paper No.41, see also McClean, D., (1992). "*International judicial assistance*", Oxford: Clarendon Press, cited by Brown

<sup>61</sup> Avgouleas, *op. cit.*, p.133

<sup>62</sup> Hellenic Capital Market Commission, *Annual Report*, 1997 p.21, Hellenic Capital Market Commission, *The Stock-Exchange crisis of November 1996*, November 1997

<sup>63</sup> obviously influenced by American theory and case law: American Law Institute, *Restatement 2nd, Torts* § 551 (2)(a) 'One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, (a)



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*matters known to him that the other side is entitled to know because of a fiduciary or other similar relation of trust and confidence between them'*; also *Remillard Brick v. Remillard - Dandini Co.*, 109 Cal. App. 2d 405 (1952) according to which: *'It is horn book law that directors.... are fiduciaries, and bear a fiduciary relationship to the corporation, and to all the shareholders. They are at duty to all stockholders, including the minority stockholders, and must administer their duties for the common benefit. The concept that a corporation is an entity can not operate so as to lessen the duties ... to all the stockholders'*.

<sup>64</sup> Monomeles Dioik. Prot. of Piraeus 187/1997, Monomeles Dioik. Prot. of Athens 80/1998, Monomeles Dioik. Prot. of Athens 140/1998

<sup>65</sup> Selekos Petros, *Episkopisi Emporikou Dikaion*, 2nd issue, 4th year, p.554

<sup>66</sup> But only by special provisions on Stock-Market Fraud (par. 88.it.2 of *Börsengesetz*)

<sup>67</sup> Article 13, Insider Dealing Directive

<sup>68</sup> Michalopoulos, *op. cit.*, at p. 102

<sup>69</sup> Michalopoulos, *op. cit.*, at p. 113

<sup>70</sup> *idem*, where at footnote 9 cited: Tunc, *La lutte contre les opérations d'initiés*, Neuf annes d'expérience, Études René Rodière, pp. 335-338

<sup>71</sup> Article 100A(1) of the Treaty of Rome

<sup>72</sup> under "*Civil Law consequences*"

<sup>73</sup> Michalopoulos, *op. cit.*, p. 117 who refers to the argumentation of Professor Manne

<sup>74</sup> see Introduction

<sup>75</sup> Kotsiris, "*Abuse of Confidential Information in American Stock Exchange Law*", Dedication to Deloukas, 1989, p. 522

<sup>76</sup> Morel, "*L'utilisation en bourse d'informations privilégiées, Evolution conceptuelle*", PhD Thesis, Paris I, 1984, cited by Michalopoulos at *supra* note 10, p. 118

## E. Remedies and Enforcement.

### a. Enforcement process and Direct Effect of the Directive

The fact that the source of the insider dealing legislation of EC Member States is the EC Insider Dealing Directive<sup>1</sup> has two practical consequences:

*Firstly*, the national legislations inspired by an EC Directive should be considered in the context of the Directive, interpreted according to a *purposive* approach and construed so as to comply with its letter and its spirit.<sup>2</sup>

*Secondly*, and more importantly, the European Court of Justice has accepted and operated the principle that the national courts of the Member States should comply with a Directive to the extent that it does not give discretion to Member States about its implementation, not only in absence of national legislation but even where the national legislation has implemented the Directive in a defective way.<sup>3</sup> In the case of *Marleasing SA v La Comercial Internacional de Alimentacion SA*<sup>4</sup>, as will be shown later in this chapter, national courts were required to ignore altogether national legislation which was in conflict with the terms of a Directive. This solution is dictated by the necessity to ensure that the conditions permitting the implementation of community measures are created and, in particular, that the directives are treated as enforceable in national law.<sup>5</sup>

The European Court of Justice (ECJ) serves as the final authority on the interpretation and application of EC law. The Court has achieved its supreme status regarding EC law through a partial surrender of legal sovereignty by EC Member States.<sup>6</sup> However, in order to retain legitimacy within its recognised sphere, the ECJ has had to maintain a delicate balancing act with the national judiciaries of the Member States. As a



result the Court is careful strictly to observe the boundaries of its jurisdiction.

The Court is empowered to interpret the growing body of EC law, and Member States are bound by the Court's interpretations. In this sense, the Court is the pinnacle of a legal structure combining hundreds of national courts.<sup>7</sup>

The Court's jurisdiction can be divided into two broad categories: actions brought directly before the Court and requests for preliminary rulings on questions of EC law brought by national Courts. The second category, cases brought under Article 177 from a national court for preliminary ruling, comprises a significant portion of the Court's caseload and has proved to be the most important in terms of development of EC law. Before discussing the Court's jurisdiction under Article 177, however, the direct bases of jurisdiction for the ECJ will be briefly examined.

### *I. Actions Brought Directly Before the ECJ.*

#### i. Actions by the EC Against a Member State (Article 169)

The Court is empowered to adjudicate cases in which the Commission has decided that a Member State has failed to fulfil its obligations under the Treaty. Recourse to the Court is allowed only after a reasoned opinion from the Commission to the Member State fails to result in compliance with the Treaty. The Court, which may not annul any national legislation, then issues a declaration that the Member State is in violation of the Treaty.

Member States are, however, obliged under Article 171 to comply with the Treaty once the Court declares that the Member State is in

violation. Thus, Article 169 actions often follow on the heels of a declaration by the Court that a Member State has failed to comply with its obligations under Article 171. Nevertheless, the prospect of repeated conflicts between the Court and a Member State under the aegis of Article 169 has not been realised because only 20 percent of proceedings commenced under Article 169 end in litigation before the Court. In addition to ensuring compliance with Treaty obligations Article 169 provides a procedure for dispute resolution and an opportunity for the Court to clarify EC law.<sup>8</sup>

The effectiveness of the Article 171 procedure is probably minimal given that a deliberately disobedient Member State can simply refuse, once again to implement a judgement given on the basis of Article 171. The situation is aggravated by the fact that the ECJ cannot impose a dissuasive penalty on such an errant State.<sup>9</sup> The only alternative measure which would not require a Treaty amendment would be to enable individuals indirectly to enforce Community Law and in particular the provisions of directives before the national courts.<sup>10</sup>

#### ii. Actions By a Member State Against Another Member State (Article 170)

The Article 170 procedures, under which a Member State may institute proceedings against another Member State for a Treaty violation, are similar to the procedures under Article 169. Before proceeding to the Court, a Member State notifies the Commission of the violation. Each Member State must submit comments; and the Commission must issue a reasoned opinion. If the Commission does not issue an opinion in three months, the complaining Member State can require the ECJ to take the case. The necessity for the Commission to issue a reasoned opinion under



both Articles 169 and 170 demonstrates the importance of the Commission in ensuring that EC law is respected by Member States and facilitates Member State compliance with EC law. Article 170, however, remains an option rarely used. Member States have preferred to allow the Commission to enforce Treaty obligations, perhaps because they view the Commission as a more detached and impartial body.<sup>11</sup>

iii. Actions Brought by Member States, the Council, the Commission or Individuals for Annulment of Administrative Acts (Article 173)

Article 173 of the EEC Treaty represents a direct control on activities of Community institutions. Under Article 173, the Court has extended judicial review over acts other than recommendations or opinions of the Council and the Commission. Complementing Article 189 of the EEC Treaty, which states that recommendations and opinions shall have no binding force, Article 173 is intended to be a mechanism for the annulment of any binding legislative act of the Council or Commission.

iv. Plea of Illegality (Article 184)

Article 184 acts as a supplement to Article 173. Because Article 173 may only be invoked within two months of the publication of an act, Article 184 provides that acts will not become immune from challenge when the two-month period elapses. However, a successful Article 184 action will only render the act inapplicable, not void.

Article 184 has also been interpreted as allowing any party to invoke the plea of illegality, even those parties precluded by Article 173, paragraph 2 from challenging general acts. Article 184 has also been termed an indirect challenge to an EC regulation because a party may claim a provision to be illegal in a proceeding brought for another purpose.

#### v. Action for Failure to Act (Article 175)

Article 175 provides Member States, individuals, or EC institutions with a remedy if the Council or Commission fails to act in conjunction with the EEC Treaty. Article 175 is similar to Article 173 in that the Court applies the individual concern test but is very little used.

### *II. Preliminary Rulings From National Courts (Article 177)*

Article 177 allows national courts to have legal questions concerning the interpretation of a treaty or Directive or the validity of an EC institution's action answered by the ECJ. It is not a mechanism for appeals to the Court from the national courts of Member States. The Court does not have jurisdiction under Article 177 to interpret or address questions of national law. It must confine itself to interpretation of EC law and may not apply the law to particular factual situations. The policy implicit in Article 177 is to ensure uniformity in the interpretation of EC law by the courts of Member States. Preliminary references from national courts under Article 177 form the backbone of the ECJ's caseload.

Article 177 provides for two types of preliminary rulings: discretionary and mandatory. Discretionary references can be brought by any level of a Member State's judiciary, and the referring court's decision need not be a final judgement. Under Article 177, paragraph 3, however, the national court of last resort "shall" refer questions of Treaty interpretation to the Court. Thus, the Court has declared that a national court or tribunal against whose decisions there is no judicial remedy under national law must refer question of EC law to the Court unless the



national court decides that:

(1) the issue is irrelevant; (2) the Court has already addressed the question; or (3) the correct application of EC law is obvious.

Article 177 gives the ECJ authority to declare EC actions invalid. When the Court declares an act of the Council of the EC void under Article 177, that ruling is binding on the national court which referred the matter to the Court. Other national courts, moreover, should regard the Court's declaration of invalidity as applicable throughout the Community. In this fashion, the Court reinforces the primacy of EC law over national law.

Article 177 has also encouraged European integration by developing the concept that certain Treaty provisions and EC acts may have "direct effects" that produce individual rights which internal courts should protect. The conditions for finding a Treaty provision to be directly effective were developed by the Court in response to Article 177 references for preliminary rulings. Direct effect will be found if the nature of the obligation is precise, if the Member State has no discretion in its application and if the obligation is unqualified, not only in the absence of legislation implementing the Directive in question but also in the case of defective implementation. Regarding the duty of Member States *vis-à-vis* directly applicable provisions, the Court has stated that "directly applicable provisions of the Treaty are binding on all the authorities of the Member States and they must therefore comply with them without its being necessary to adopt national implementing provisions."<sup>12</sup> Provisions having direct effect are enforceable by private individuals in their national courts.<sup>13</sup>

The Court has sought to maximise the effectiveness of Directives in Community law motivated by a strong desire to safeguard the interests of

potentially affected parties by affording them a genuine opportunity to seek redress in the national courts.<sup>14</sup> At this point it should be noted that the *direct effect* of a directive is applicable only if the provisions of the directive confer '*directly effective rights on individuals*'.<sup>15</sup> In the context of the Inside Dealing Directive this is not the case. The provisions of the Directive impose a specific obligation on Member States to legislate against the offence of insider dealing and to adopt sanctions that are sufficient to promote compliance. It could hardly be argued that any individual rights are conferred to persons under the Directive. If the Directive did not give discretion regarding sanctions and provided for a specific civil remedy that the victims of the offence should have against the offender, the principle of direct effect, as developed by the ECJ would be of substantial importance because individuals would be able to seek enforcement of the Directive before national courts in case of its non-implementation or, even, defective implementation. The fact, however, that a Community law provision can be considered as directly effective does not of itself determine whether the right created in the individual is to be categorised by national law as a private law right to be protected by such remedies as the national legal system provides for such a right, or as a right to have the public law enforced, to which are attached the remedies appropriate for such enforcement.<sup>16</sup> Curtin remarks that, in as much as it is for the national court to give effect to Community rights, the remedies offered must be effective. This analysis leads to the conclusion that Community law may require national courts to make available, pursuant to the failure by a Member State to implement a directive into national law, a remedy in damages vested in those individuals injured by national public authorities' violation of Community law.<sup>17</sup>

Two preliminary rulings of the ECJ, quite appropriately related to



Company-Securities law Directives, illustrate the current tendencies towards the acceptance of the "direct effect" of EC Directives.

In *M. Karella and N. Karellas v Minister of Industry, Energy and Technology* (intervenor: Organismos Anasinkrotiseos Epikhiriseon AE or "Organisation for Economic Recovery of Business Enterprises")- 30 May 1991<sup>18</sup>, the Council of State of the Hellenic Republic referred three questions on the interpretation of Articles 25, 41 and 42 of the second Council Directive (77/91/EEC) for a preliminary ruling.

In 1983, by decision of the Secretary of State for the Economy, the provisions of Greek Law No. 1386/1983 were applied to the company Klostiria Velka AE, which was experiencing serious financial difficulties. Pursuant to Article 8 of that law, temporary management of the company was transferred to the OAE, a public body for the restructuring of undertakings.

During that period of administration, the OAE decided to increase the Company's share capital by 400,000,000 drachmas. That decision was approved by the Secretary of State for Industry, Energy and Technology. The decision granting approval made provisions for an unfettered right of redemption for existing shareholders, which they had to exercise within one month.

By its questions referred for a preliminary ruling, the national court asked whether, having regard to Article 41(1) of the second Directive, Article 25(1) of the same Directive can be relied upon against the State before a national court by an individual and whether it was applicable in respect of public rules, such as those laid down by Law No. 1386/1983, which deal with the entirely exceptional circumstances of companies of particular economic and social importance for society as a whole which are experiencing serious financial difficulties.

The Court ruled as follows:

*"1. Article 25(1) of the Second Council Directive (77/91/EEC) of 13 December 1976 on co-ordination and safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance or alteration of their capital, with a view to making such safeguards equivalent, may be relied upon by individuals against the public authorities before national courts.*

*2. Article 25 in conjunction with Article 41(1) of the Second Directive must be interpreted as meaning that they preclude national rules which, in order to ensure the survival and continued operation of undertakings which are of particular economic and social importance for society as a whole and are in exceptional circumstances by reason of their excessive debt burden, provide for the adoption by administrative act of a decision to increase the company capital, without prejudice to the preferential right of existing shareholders when the new shares are issued."*

Mr Advocate General Giuseppe Tesauo delivered his opinion at the sitting of the Sixth Chamber on 30 January 1991. He concluded as follows:

*"In the light of the foregoing considerations, I propose that the questions referred by the Greek Council of State should be answered as follows:*

*I. The provisions of Article 25 in conjunction with Article 41(1) of Council Directive 77/91/EEC are unconditional and sufficiently precise<sup>19</sup> that they can be relied upon against the State before the national court by an individual claiming that they are incompatible with the rules contained in a legal provision.*

*II. The provisions of Article 25 in conjunction with Article 41(1) of Council Directive 77/91/EEC must be interpreted as meaning that they preclude the application of rules which, while seeking to govern the management of certain undertakings in a situation of crisis, without prejudice to the preferential right of existing shareholders, permits a decision to be taken to increase the company capital*



*by an administrative act and without consideration by the meeting of shareholders."*

The *ratio decidendi* of the *Karella* case has been criticised<sup>20</sup> as failing on the one hand to reconcile the Directive with the national law and to safeguard the coherence of legal institutions, and, on the other, as not embracing in its reasoning the whole body of law even if, as Curtin points out, this body consists for a large or major part of national law rules. This was one of the issues dealt with by Advocate General Van Gerven in the *Marleasing* case.

In *Marleasing SA et La Comercial Internacional de Alimentación SA*, C-106/89, arrêt de la cour (sixième chambre), 13 November 1990, a ruling along the same lines can be found. The Court of Justice has developed a parallel obligation, imposed on national courts, to interpret their national laws in the light of the objective and the wording of any pertinent Community directives, in order to guarantee the effectiveness of the individual's rights even in a horizontal relationship (*i.e.* in a private law relationship between individuals and not only in claims which by their nature will always be enforced against the State). According to the Court when applying national law, no matter if it concerns provisions that were enacted before or after the Directive, the national jurisdiction when called to interpret must do so in the light of the text and the objective of the Directive in order to achieve the result envisaged by the latter and being, therefore, in conformity with Article 189 of the Treaty. This obligation of national courts emerges as rather extensive and far-reaching from the judgement of *Marleasing*. The case concerned the attempt by Marleasing S.A. to obtain a declaration of the nullity of La Comercial Internacional de Alimentación S.A. from a Spanish tribunal on the ground that it was vitiated by the lack of (lawful) consideration in violation of Articles 1261 and 1275 of the Spanish Civil Code. In its defence

La Comercial relied on Article 11 of the first Company law Directive<sup>21</sup> which lists exhaustively the cases in which the nullity of a company may be declared, not including the lack of (lawful) consideration, which had not been implemented at that point in time into Spanish law. The national tribunal considered that the case raised the problem of the direct effect of a directive which had not been transposed into national law and accordingly it asked the Court of Justice whether Article 11 of the Directive in question could be considered as directly effective in a *horizontal* context. The Court, as Curtin comments<sup>22</sup>, 'neatly side-stepped this response by rewording the question asked in terms of the existence or otherwise of an obligation to interpret national law in conformity with the provisions of a directive'. The national court was informed by the ECJ that it was obliged to interpret its national law, irrespective of whether it pre-dated or post-dated the pertinent directive, in the light of the terms of the directive. The end result was that the obligation contained in the directive is placed on *private parties*, albeit after having been transformed, via judicial interpretation, into one of national law. In this manner "horizontal" rights, which are enshrined in directives, can have the force of law as between individuals without a specific domestic legislative process and the primacy of Community law is assured.

The availability of adequate judicial remedies for the protection of individuals in the national courts in relation to enforceable Community rights may be described as an essential requirement of Community law. This general principle of effectiveness of judicial protection has been encapsulated in legislative form in two notable areas: *First*, in the directives relating to equal treatment of male and female workers, Member States are required to adopt measures which are sufficiently effective to achieve the objective of the directive. *Second*, with regard to



public procurement, the recently published draft "Compliance Directive" relating to the application of Community rules on procedures for the award of contracts in the fields of water, energy, transport and telecommunications ("excluded sectors") makes reference to the obligation on Member States to provide effective legal means of recourse with a view to setting aside decisions violating Community legislation and national implementing legislation as well as to provide for the compensation of injured tenderers.<sup>23</sup>

Community law may carry the enforcement measures one step further and require national courts to make available, pursuant to the failure by a Member State to implement a directive into national law, a remedy in damages against the national state (as opposed to a mere declaratory order) vested in those individuals injured by the national public authorities' violation of Community law. There is some authority in the case law of the ECJ for the proposition that the interest of having a judgement by the Court in the context of proceedings under Article 169 of the Treaty is that it may establish the basis of the *liability* the State may incur, in particular towards individuals as a result of the breach of its obligations.<sup>24</sup> This argument has been reiterated by the Court in the context of an action concerning a Member States' failure to transpose correctly a Directive into national law.<sup>25</sup>

In the absence of any Community harmonisation the arrangements for the compensation of individuals injured by an unlawful act of a public authority is still governed by the national legal systems with the corollary that the systems both of evidence and of estoppel prevailing in the separate Member States will apply, thereby jeopardising any hope of attaining a uniform system of rules. Nevertheless, the principle that the State is liable is acknowledged in all the Member States provided that the

damage was caused by the public authority in the exercise of their functions.<sup>26</sup> Whereas under no national legal system is liability arising from acts in the nature of secondary legislation automatically excluded, in a majority of Member States fault by a public authority has to be demonstrated and only in a minority of states, is an unlawful act by an authority equivalent to fault.<sup>27</sup> For the common law jurisdictions an analogy may be drawn between the tort a Member State commits in failing to implement the provisions of a directive into national law in time, if the directive provides for the protection of individual rights, and the cause of action arising out of a breach of a public duty under a statute.<sup>28</sup>

National courts are obliged on the basis of the general obligations imposed upon Member States in Article 5 of the Treaty, to draw the consequences flowing from their State's membership of the Community and they must determine the extent of the protection national law offers individuals affected by any breach of provisions of Community law, which establish individual rights, in accordance with the Community law principle of effectiveness and appropriateness. This idea was expressed in *Russo*<sup>29</sup> by Advocate General Reischl who stressed that:

*"the liability of a Member State for the consequences flowing from an infringement of Community law also arises out of the obligation to provide effective protection of these rights provided that the other prerequisites under national law are present".<sup>30</sup>*

It may be argued that where a Member State acts in breach of the directly effective provisions of Community law, any loss or damage suffered by an individual as a consequence sound in damages. The failure by a Member State to implement the directly effective provisions of, in the event, a directive into national law occasions the breach of individual rights which are deemed to be absolute and which lead to an action in damages. According to this analysis it would be incompatible with



Community law for a national court to subject an injured individual's right to obtain damages from the State for violation of a directly effective right to the further restrictive proof of an abuse of power by the Member State.<sup>31</sup>

In the context of the Insider Dealing Directive special problems are posed. It has already been mentioned that the Directive does not confer any individual rights on persons and that only if it provided for certain civil law remedies it could be argued that private persons would be in a position to benefit from the direct effect (vertical or horizontal) of the Directive. As regards damages, it should be remembered that insider dealing is often perceived as a victimless crime or, at least, a crime without easily identifiable victims and even less easy to prove damages.

An important question in this respect is whether private individuals who have been adversely affected by the failure of a Member State to implement the terms of a Directive into national law should be able to claim compensation against the State for damage sustained as a result, even in relation to provisions of the directive which do not enjoy direct effect in the formal sense.<sup>32</sup> It can be argued that it would be incompatible with the binding effect attributed to a directive by Article 189 of the Treaty to exclude, in principle, the possibility that the obligation which it imposes may be invoked by those individuals whose rights have been directly or indirectly adversely affected by the Member State's failure to implement correctly or on time, even where the norm in question may not enjoy direct effect as such.<sup>33</sup> The existence of such effect, as Curtin remarks, would constitute an important additional weapon in the legal armoury of vigilant individuals affected by a Member State's failure to transpose correctly, and in good time, the provisions of a directive into national law.

## **b. Between EC Member States**

The Treaty on European Union<sup>34</sup> was signed on 7 February 1992 at Maastricht in the Netherlands. It entered into force on 1 November 1993. The High contracting parties are the twelve Member States of the European Communities. Title VI of the Treaty is entitled Co-operation in the Fields of Justice and Home Affairs. The Governments of the Member States of the European Communities have in fact co-operated in these fields for several years. They have done so outside the framework of the Community Treaties, and thus outside the Community legal order. Title VI of the Maastricht treaty provides a treaty basis on home affairs and justice matters. Co-operation under Title VI takes place outside Community procedures. The resulting decisions form no part of Community law.<sup>35</sup>

Title VI consists of ten articles: Articles K to K.9. Article K states simply: "Co-operation in the fields of justice and home affairs shall be governed by the following provisions". Accordingly, such co-operation is not governed by earlier provisions of the Treaty, in particular those relating to the Communities. Articles K.1. to K.8. describes how that co-operation is to be carried out in a number of defined policy areas regarded as "matters of common interest". Article K.9 establishes a procedure for transferring some of these matters to the EC Treaty, thus placing them within Community competence. Title VI does not contain substantive rules of law regulating the matters of common interest. It is rather a legal framework for intergovernmental co-operation between the Member States in these policy areas. The nine areas of common interest encompass asylum and immigration [Art. K.1(1) to (3)]; combating drug addiction and fraud [Art. K.1(4) and (5)]; judicial co-operation in civil and criminal



matters [Art. K.1(6) and (7)]; and customs and police co-operation [Art. K.1.(8) and (9)].

Article K.1(6) lists as a matter of common interest "judicial co-operation in civil matters", and Article K.1 (7) "judicial co-operation in criminal matters".

The term "judicial co-operation" is misleading. It might suggest no more than co-operative arrangements between the domestic courts of the Member States. But in practice it has come to be used as a shorthand for a larger process. Each Member state has retained its own distinctive civil and criminal legal system, and in some Member States there are distinct regional legal systems. The Member States have guarded these jealously, and opposed the notion of Community competence over such matters as the organisation of the courts and administration of justice, rules of evidence, civil procedures and remedies, and criminal procedures and penalties. In general these matters as well as substantive criminal law and most areas of civil law, remain within the national competence of Member States. But the Member States have long acknowledged the need to co-operate closely to improve the efficiency and interaction of their legal systems within the Community. This need increased with the establishment of the single market, bringing with it freer movement of goods, services, capital and people within the Community.

Judicial co-operation, involving a regular process of exchange of information, consultation, and agreement on subjects ranging from extradition to maintenance payments, was carried out in recent years as part of European Political Co-operation. The process also involved discussion and co-ordination of Member States' positions in wider international *fora* such as the United Nations, the Council of Europe, and the Hague Conference on Private international Law. This work can be

expected to intensify under Title VI of the Maastricht Treaty.

In the civil law field, action has also been taken in pursuance of Article 220 of the EC Treaty. This provides, *inter alia*, that "Member States shall, so far as necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals...the simplification of formalities governing the reciprocal recognition and enforcement of judgements of courts and tribunals and of arbitration awards". Notable achievements have been the 1968 Brussels Convention on Jurisdiction and the Enforcement of Judgements in Civil and Commercial Matters<sup>36</sup> and the 1980 Rome Convention on the Law applicable to contractual Obligations.<sup>37</sup> The possibility of concluding further conventions pursuant to Article 220, and thus within the framework of the Community Treaties (though not in the form of Community legislation) remains unaffected by Title VI.

Title VI makes an important legal distinction between civil and criminal judicial co-operation. Only action in the field of judicial co-operation in civil matters, since that field is referred to in Article K.1 (6) may be transferred to Article 100c of the EC Treaty and thus into Community competence in accordance with Article K.9; and it is only in respect of judicial co-operation in civil matters that the Commission shares the right of initiative with Member States under Article K.3(2). This distinction reflects the greater sensitivity of Member states about their powers in the field of criminal justice.

The main forms of co-operation provided for by Article K.3 are exchange of information and consultation [para (1)], joint action [para (2)(a&b)] and more importantly the drafting of Conventions [para 2(c)] that will be recommended for adoption by Member States.

In addition Article K.5 of the Maastricht Treaty provides that:



*'Within international organisations and at international conferences in which they take part, Member States shall defend the common positions adopted under the provisions of this Title.'*

The Council of Europe Convention on Insider Trading<sup>38</sup>, as has already been mentioned, represents an important attempt to facilitate multilateral co-operation for the enforcement of laws prohibiting insider dealing. In the European level it is an effort to further the objectives of EC Council Directive 89/592.

The main undertaking of the Contracting States is "to provide each other with the greatest possible measure of mutual assistance in the exchange of information relating to matters establishing or giving rise to the belief that irregular operations of insider trading have been carried out."<sup>39</sup> Assistance is due when there is reasonable suspicion that insider trading has occurred and should be taken to include providing access to information in the files of the requested authority, taking evidence of persons and obtaining documents. Each State must designate authorities responsible for submitting and for receiving requests for assistance.<sup>40</sup> Such authorities may be administrative or judicial, and each State may designate more than one if it considers it necessary.<sup>41</sup> The execution of the requests is carried out in accordance with the law of the Contracting Party where the requested authority operates and, in the absence of specific provisions, the latter may apply the rules laid down by national law of obtaining evidence.<sup>42</sup> These provisions may not prejudice the rights accorded to the defendant by national law.<sup>43</sup> In this context, sanctions laid down for breaches of professional secrecy shall not apply in regard to the information provided compulsorily by witnesses in the course of an enquiry.<sup>44</sup>

The undertaking of the requested authority to supply information is

conditional upon the facts on which the request is based constituting insider dealing as defined by the Convention and, in addition, constituting "in each State an irregularity as regards the rules of both States."<sup>45</sup> As has already been remarked in the previous chapter, this inserts a requirement of "*dual irregularity*"<sup>46</sup> and means that the facts must constitute according to the laws of both the requesting and the requested States a criminal offence or an infraction subject to administrative, disciplinary or civil sanctions, but not an infraction for which damages is the only civil sanction.<sup>47</sup> Reference to "disciplinary sanctions" suggests that the communication network could be used for the enforcement of self-regulatory rules.

The Convention establishes a multilateral network of communication under flexible and expedient procedures and facilitates continuity in co-operation. Nevertheless, the scope of its application is limited in two ways. First, the requirement of "dual irregularity" is an important restriction. Article 10 of the EC Directive specifically requires the exchange of information upon the request of a Member State even where the relevant action is not prohibited by the law of the requested State. Secondly, the Convention solely incorporates an undertaking of "passive assistance".<sup>48</sup> It imposes upon a state the obligation to provide information in connection with the suspected violation of the insider trading laws of another State if the latter so requests. It does not require the authorities of a Contracting State when they have reason to suspect that a breach of the insider trading laws of another State has occurred to inform the authorities of the latter. This type of "active assistance" is not institutionalised and remains for each Contracting Party to pursue in its own initiative. It should be noted that this type of "active assistance" is expressly included in the Memorandum of Understanding concluded



between the SEC of the United States and the Ontario, Quebec and the British Columbia Securities Commissions in 1988. Article 8 of the Memorandum entitled "Unsolicited Assistance" provides: "To the extent permitted by the laws and regulations of its jurisdiction, each authority will use reasonable efforts to provide the other authority with any information it discovers which gives rise to a suspicion of a breach, or an anticipated breach, of the laws and regulations of the other Authority."<sup>49</sup>

The Council of Europe Convention on Extradition<sup>50</sup>, to which the United Kingdom has become a party, is a very important achievement of the EC legislation as regards interstate co-operation and enforcement of insider dealing rules. The Convention requires [Art. 2(1)] that, before extradition is granted, the offence be one which is punishable under the laws of both the requesting and the requested party by deprivation of liberty for at least one year. If this condition is satisfied, subject to the rest of that Convention, State Parties are obliged to extradite. As Alastair Brown has observed: 'hitherto, insider dealing was not an extradition crime.'<sup>51</sup> Once all EU Member States have complied with the Directive and prohibited insider trading,<sup>52</sup> the criteria in Article 2(1) of the Extradition Convention are likely to be met in all cases of insider dealing, at least between EU countries, if the latter do not use pecuniary penalties as the only punishment for the insider dealing offence. It should therefore be possible to secure the return of offenders and face the difficulties experienced in prosecuting insider dealing which is largely a cross-border phenomenon, likely to be related to more than one jurisdiction.

### c. At an International level.

Increasing internationalisation of securities markets has made more difficult the task of prosecuting multi-jurisdictional insider trading. Difficulties are exacerbated when an international element is present for a variety of reasons. An inside transaction may take place in the securities of an issuer from outside the country where the securities are traded. Offences may be carried out by persons operating in a market outside the State where they reside and often through nominees so that the identity of the offenders becomes more difficult to determine. In these cases it is necessary to collect evidence which is located abroad but this process faces particular difficulties and the existing instruments for international co-operation are not designed to facilitate the exchange of information in connection with this type of abuse. Enforcement may be further hampered by banking secrecy and blocking laws in force in some jurisdictions, which restrain the disclosure of material information to foreign regulatory bodies.

In view of these difficulties, national authorities have sought to expedite enforcement of securities laws by mutual co-operation. Three types of incentives can be distinguished: *First*, the inclusion in national statutes of provisions empowering domestic authorities to disclose information to their foreign counterparts and, even, to initiate investigations at the request of the latter. Such provisions have been included in the laws of France,<sup>53</sup> the United Kingdom and the United States.<sup>54</sup> *Secondly*, by mutual recognition arrangement for mutual legal assistance in securities markets. The American Securities and Exchange Commission and securities regulators from other countries have directed recent efforts at co-operation in insider trading investigation and



enforcement at formal bilateral agreements, including mutual legal assistance treaties and Memoranda of Understanding (MOUs). This process begun in the 1970's and has gained wide acceptance via the International Organisation of Securities Commissions (IOSCO), which in 1986 adopted a resolution on co-operation obliging members to provide assistance on a reciprocal basis for gathering information related to market oversight and protection of each nation's markets against fraudulent securities transactions.<sup>55</sup> Twenty-three securities regulators, including the SEC, subsequently ratified the resolution.<sup>56</sup> In 1989, the SEC proposed another resolution encouraging the formalisation of this process by advising IOSCO members to negotiate for comprehensive MOUs on information sharing arrangements. IOSCO's Technical Committee endorsed the resolution, which was opened for signature in June 1989. Such efforts at bilateral negotiations have achieved significant success, replacing earlier efforts at a multilateral approach, as represented by the Hague Convention (on Taking Evidence Abroad in Civil and Commercial Matters).<sup>57</sup>

Mutual assistance treaties provide procedures for mutual help in the investigation of criminal matters. The principal treaty for mutual assistance is the Treaty on Mutual Assistance in Criminal Matters Between the Swiss Confederation and the United States (Swiss Treaty).<sup>58</sup> The Swiss Treaty was the first mutual assistance treaty of its kind to which the United States was a party. It provides that the U.S. and Swiss governments will provide for "broad assistance in ... criminal matters ... includ[ing] assistance in locating witnesses, production and authentication of business records, and service of judicial or administrative documents."<sup>59</sup> The treaty applies to all areas of "dual criminality", except customs, tax, and antitrust law. This dual criminality requirement hampered SEC efforts to utilise the

Swiss Treaty in insider trading cases, because Switzerland did not have laws expressly prohibiting insider trading until the enactment of Article 161 of the Swiss Penal Code (SPC) on 1 July 1988. The enactment of Article 161 of the SPC will greatly expand the SEC's ability to obtain information from Switzerland for investigations of insider trading violations. Differences, however, in U.S. and Swiss insider trading prohibitions may make the Swiss Treaty provisions inapplicable in some SEC insider trading investigations.

The United States has also entered into criminal mutual legal assistance treaties with Netherlands, Turkey and Italy.

Memoranda of Understanding (MOUs) are "non-binding statements of intent between like-minded regulators, providing for exchanges of information and mutual co-operation on a bilateral basis."<sup>60</sup> Although the SEC's first negotiated MOU, the Memorandum of understanding between the United States and the Confederation of Switzerland (Swiss MOU), was designed specifically to address insider trading violations, subsequent MOUs cover a broad range of securities law matters. MOUs provide:

*'an efficient, predictable, and reliable means of obtaining information in securities enforcement matters. In addition, they assist in developing (1) a framework for co-operation; (2) greater experience in addressing international securities law issues; (3) improved communications; and (4) improved working relationships. MOUs are specifically designed to assist the parties in their international enforcement efforts and generally allow requests to be made and processed directly between securities authorities.'*<sup>61</sup>

In addition, because most SEC negotiated MOUs do not have a dual criminality requirement, they offer an important advantage over mutual assistance treaties in insider trading investigations. The SEC has negotiated and entered into MOUs with Switzerland, the United



Kingdom, Japan, the Canadian provinces of Ontario, Quebec, and British Columbia, Brazil, Italy, the Netherlands and France. The MOU with France deserves special mention. It is entitled the Administrative Agreement between the U.S. Securities and Exchange Commission and the Commission des Opérations de Bourse (COB). It is comprehensive in scope and binding in nature,<sup>62</sup> providing that the SEC and the COB may use their respective compulsory powers to aid one another in matters falling within the scope of the agreement. This provision has required national legislation authorising such powers, such as Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), which expands the SEC's authority to conduct investigations at the request of a foreign securities authority, and by the French law of 2 August 1989, which gave the COB the authority to gather information on behalf of foreign securities authorities. As one commentator points out, "this is significant because the domestic regulatory authority, in this case the COB, is recognising foreign legislative authority, here the SEC, as co-equal with or pre-emptive of its own legislative authority with regard to illegal behaviour."<sup>63</sup>

The French Agreement illustrates the limitations of mutual recognition. The laws and regulations applicable to securities regulation are still derived from, and rely on, national political and legal mechanisms.<sup>64</sup> On the other hand, the time involved and costs associated with negotiating narrow bilateral co-operative agreements are considerable. Finally, unless the regulatory regimes involved in reciprocal agreements offer certain minimal levels of protection in common areas of regulation, there is little basis for mutual recognition as is exemplified by the limitations of the U.S.-Swiss co-operative efforts to regulate insider trading under the dual criminality requirement. Thus, mutual recognition

offers little help in areas where regulatory regimes differ not with regard to methods but with regard to the objectives of regulation.

In today's internationalised securities markets the crime of insider trading presents new and difficult challenges to securities regulators. The future of effective regulation in this area depends not on extraterritorial exertion of national jurisdiction but rather on co-operative regulatory efforts. The EC Directive on Insider Dealing is the most advanced example of international co-operation in this area. Although it is not a supranational regulatory scheme, it is an effective statement of the co-ordination and harmonisation of regulatory policy in the area of insider trading. As such, it provides a model for future co-operative securities regulation efforts in the modern globalised markets. The adoption of uniform rules, while desirable from the point of view of regulatory certainty and effectiveness, is not realistic in the world as it exists today.<sup>65</sup>

## NOTES

<sup>1</sup> 89/592/EEC OJ L334/30

<sup>2</sup> J. Murray, "The New Insider Dealing law: A Critique", *Insider Dealing*, Papers presented at a Seminar, Edinburgh, 27 August 1993, The David Hume Institute, Edited by H. L. MacQueen, Hume Occasional Paper No.41, p. 20

<sup>3</sup> idem, on 'direct effect' see: Eleftheriadis Pavlos, "The Direct Effect of Community Law: Conceptual Issues", *Yearbook on European Law*, 1996, vol. 16, p. 205

<sup>4</sup> [1990] 1 ECR 4135

<sup>5</sup> Deidre Curtin, "Directives: The effectiveness of judicial protection of individual rights", *Common Market Law Review* 27: 709-739, 1990, p. 709, see also: Frank Emmert & Monique Pereira de Azevedo, "L'effet horizontal des directives - La jurisprudence de la CJCE: un bateau ivre?", *Revue Trimestrielle de Droit Européen*, 29 (3) juill.-sept 1993, pp. 502-524

<sup>6</sup> The incorporation of Community Law into the legal framework of Member States has



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proceeded unevenly since the adoption of the EEC Treaty. The EEC Treaty did provide, in Article 189, paragraph 2, that regulations would be "directly applicable" in the Member States. The court describes a "directly applicable" provision as one which "produces immediate effects and as such is capable of conferring on parties rights which the national courts must protect." *Riccarda Tasca Case*, C.65/75, E. Comm. Ct. J. Rep. 291, [1977] 2 Comm. Mkt. L. R. 183, 203

<sup>7</sup> P. Kapteyn & P. Verloren Van Themaat, *"Introduction to the Law of the European Communities: After the coming into force of the European Single Act"*, L. Gormley, 2nd edition 1989

<sup>8</sup> Josephine Steiner, *"Textbook of EEC Law"*, 2nd edition

<sup>9</sup> Deidre Curtin, *supra* note 5, p. 711

<sup>10</sup> *idem*

<sup>11</sup> P. Kapteyn & P. Verloren Van Themaat, *supra* note 2

<sup>12</sup> Case 26/62, 1963 E. Comm. Ct. J. Rep. 1, [1963] 2 Comm. Mkt. L. R., 105, on 'direct effect' see also: Eleftheriadis Pavlos, "The Direct Effect of Community Law: Conceptual Issues", *Yearbook on European Law*, 1996, vol. 16, p. 205

<sup>13</sup> D. Rheid & An. Balheimer, "The Legal Framework of The Securities Industry In The EC Under the 1992 Program", *Columbia Journal of Transnational Law*, v. 29, 1991, n. 1

<sup>14</sup> Deidre Curtin, *supra* note 5, p. 716

<sup>15</sup> Deidre Curtin, *supra* note 5, p. 713

<sup>16</sup> Deidre Curtin, *supra* note 5, p. 730

<sup>17</sup> Deidre Curtin, *supra* note 5, p. 731

<sup>18</sup> *British Company Cases*, p. 677, 1993, [Joined Cases C-19/90 and C-20/90]

<sup>19</sup> emphasis added

<sup>20</sup> A. Samara-Krispis & E. Steindorff, *Common Market Law Review*, 1992, p. 622

<sup>21</sup> Council Directive 68/151 of March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second para. of Art. 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community (O.J. English Special Edition 1968 (1) p. 41)

<sup>22</sup> Deidre Curtin, *supra* note 5, p. 724, see also the analysis of Frank Emmert & Monique Pereira de Azevedo, "L'effet horizontal des directives - La jurisprudence de la CJCE: un bateau ivre?", *Revue Trimestrielle de Droit Européen*, 29 (3) juill.-sept 1993, pp. 502-524

<sup>23</sup> COM(90) 297 final, O.J. 1990 c 216/8

<sup>24</sup> Case 39/72, *Commission v. Italy*, [1973] ECR 101

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<sup>25</sup> Case C-287/87, *Commission v. Greece*, judgement of 18 Jan. 1990, the more recent *Francovich* (CJCE, 19 Nov. 1991, *Francovich* aff. jtes C6 et 9/90, Rec., 1991, p. I-5357) [on the directive 80/987 which imposed on Member States the obligation to adopt legislative, administrative and regulatory measure with a view to organising a guarantee mechanism in order to secure payment of employees in the case of the employer's insolvency] has recognised to individuals the right to bring an action in damages against the Italian state. This recognition of *horizontal effect* is connected with a Directive that creates a precise and unconditional obligation to a Member State and an equally precise and unconditional right to individuals.

<sup>26</sup> Deidre Curtin, *supra* note 5, p. 732

<sup>27</sup> i.e. Belgium, France and Luxembourg, Deidre Curtin, *supra* note 5, p. 733

<sup>28</sup> Deidre Curtin, *supra* note 5, p. 733, who cites: *Garden Cottage Foods v. Milk Marketing Board* [1983] 2 AllER 770

<sup>29</sup> [1976] ECR 45, 58 cited by Deidre Curtin, *supra* note 5, p. 734

<sup>30</sup> *idem*, emphasis of D. Curtin

<sup>31</sup> Deidre Curtin, *supra* note 5, p. 737

<sup>32</sup> Deidre Curtin, *supra* note 5, p. 739, see cases cited therein and footnote 134

<sup>33</sup> *idem*

<sup>34</sup> The text of the Treaty, and of the Final Act and Declarations adopted by the Intergovernmental Conference at Maastricht on 7 February 1992, were published in the Official Journal of the European Communities No. C 191 of 29 July 1992

<sup>35</sup> I.D.Hendry, "The Third Pillar of Maastricht: Cooperation in the Fields of Justice and Home Affairs", *German Yearbook of International Law*, Volume 36, 1993, p. 295

<sup>36</sup> OJ No.L299 of 31 December 1972, the Convention was amended on the accession of Denmark, Ireland and the U.K. (OJ No. L 304 of 30 October 1978), Greece (OJ No. L 388 of 31 December 1982), and Spain and Portugal (OJ No. L 285 of 3 December 1989).

<sup>37</sup> OJ No. L 266 of October 1980, amended in 1984 (OJ No. L 146 of 31 May 1984), and 1992 (OJ No. L 333 of 18 November 1992)

<sup>38</sup> Council of Europe, No 130, open for signature on April 20, 1989

<sup>39</sup> Convention on Insider Trading, Art. 2

<sup>40</sup> Convention on Insider Trading, Art. 4

<sup>41</sup> Explanatory Report on the Convention, pp. 9- 10

<sup>42</sup> Convention on Insider Trading, Art. 6(1) and (2)

<sup>43</sup> Convention on Insider Trading, Art. 6(3)

<sup>44</sup> Convention on Insider Trading, Art. 6(2)



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- <sup>45</sup> Convention on Insider Trading, Art. 7(2)
- <sup>46</sup> T. Tridimas, "Convention on Insider Trading", *European Law Review*, October 1991, p. 441
- <sup>47</sup> Explanatory Report on the Convention, p. 12
- <sup>48</sup> T. Tridimas, *supra* note 46, p. 442
- <sup>49</sup> quoted by Tridimas, at *supra* note 46, p. 442
- <sup>50</sup> Alastair Brown, "Insider Dealing and the Criminal Law", in *"Insider Dealing: Papers presented at a seminar, Edinburgh, 27 August 1993"*, Edited by H. L. MacQueen, The David Hume Institute, Hume Occasional Paper No 41, p. 17
- <sup>51</sup> *idem*, p. 18
- <sup>52</sup> Germany was the last Member State to implement the Insider Dealing Directive in June 1994, see also: Lorenz Frank, "Control of Insider Dealing in Germany: Proposed Reform", *Journal of International Banking Law*, [1993] 8, pp. 318-322
- <sup>53</sup> Ordonnance 67-833 of September 28, 1967, Art. 5bis added by Loi 89-531 of August 2, 1989, Art. 3
- <sup>54</sup> Securities and Exchange Act of 1934, s.21(a) as amended by the Insider Trading and Securities Fraud Enforcement Act of 1988 and s.24(c) as amended by the International Securities Enforcement Co-operation Act of 1990
- <sup>55</sup> Charles Vaughn Baltic III, "The next step in insider trading regulation: International Co-operative Efforts in the Global Securities Market", *Law & Policy in International Business*, Vol. 23, 1991-1992, p. 189
- <sup>56</sup> *idem*
- <sup>57</sup> opened for signature Mar. 18, 1970, 23 U.S.T. 2555, cited by Vaughn Baltic, *supra* note 55
- <sup>58</sup> U.S. - Switz., May 25, 1973, 27 U.S.T. 2019 (entered into force Jan. 23, 1977), cited by Vaughn Baltic, *supra* note 55
- <sup>59</sup> quoted by Vaughn Baltic, *supra* note 55, p. 190
- <sup>60</sup> M.D. Mann & L.A. Lustgarten, *Internationalisation of Insider Trading Enforcement: A Guide to Regulation and Co-operation*, Address to the American Bar Ass'n (Mar. 1-2, 1990) quoted by Vaughn Baltic, *supra* note 55, p. 190
- <sup>61</sup> *idem*
- <sup>62</sup> *idem*
- <sup>63</sup> Charles Vaughn Baltic III, *supra* note 55, p. 192
- <sup>64</sup> *idem*
- <sup>65</sup> see: Steven R. Salbu, "Regulation of insider trading in a global marketplace: a uniform statutory approach", *Tulane Law Review*, Vol. 66, 1992, pp. 837-869

## F. Conclusion

The two most significant contributions of the Community legislation towards the achievement of a common market in the field of investor protection are, on the one hand, an increased level of Prudential Re-regulation and, on the other, the establishment of Regulatory Harmony.

Increased Prudential Re-regulation should benefit investors. The EC Directives combine numerous safeguards to protect investors from abuse through more comprehensive disclosure obligations, thereby promoting public confidence in both primary and secondary securities markets. Increased public confidence and analysis of corporate disclosures should stimulate the development of a stronger retail securities market in Europe. These factors should not only attract and protect investors, but also provide them with greater opportunities for portfolio diversification.<sup>1</sup> Assessment of risk and allocation of resources should vastly improve due to the increased availability of comparable information. The probable result of the EC's disclosure rules will be an improvement of investors' ability to analyse securities on a transnational basis, previously the major obstacle to cross-frontier trading in the common market.

Corporate issuers and financial intermediaries will be equally benefited by the greater transparency and liquidity in the market of securities which prudential re-regulation is due to bring about.

The second major contribution of the EC's initiatives is the Regulatory Harmony resulting from the "supranational accommodation of the diverse laws of the individual Member States."<sup>2</sup> Regulatory Harmony provides investors with greater access to the EU securities markets. Investment firms seeking to accommodate them will also benefit significantly from participation in a larger single market. Reduced



regulatory barriers will make the development of pan-European distribution system more attractive, and could well stimulate more participation in retail markets and more demand for corporate securities.<sup>3</sup>

An overall goal of the EC Directives is to achieve an internationalisation of the EU capital markets. Mutual recognition of listing particulars and public offer prospectuses within the EU should make it easier and cheaper to obtain listings and to make public offerings throughout the Community. Corporate issuers may turn to EU securities markets as an alternative to United States capital markets to avoid disclosure and other requirements. Another purpose of the directives is to promote greater competition in the financial services sector and a reduction in costs to the consumer, since financial firms can more easily establish and sell products in other Member States and can better face competition in their Home State because they won't be exposed to unequal competition from abroad.

#### **Positive aspects and deficiencies of the EC Insider Dealing Regulation**

The "*zeal to squash insider-trading*"<sup>4</sup> has been criticised by economists. The latter mainly argue that insider dealing can make stock-markets work more efficiently and that this can benefit investors as a whole. If insiders trade on their information, according to these arguments from economic theory, stock prices come to reflect that knowledge more accurately and sooner than they would do had the insider not traded. More accurate prices mean less of a risk for investors, who will then require a smaller reward, or risk-premium, for buying the shares. Companies can raise capital more cheaply and invest more contributing, thus, to economic growth.

A logically similar argument could be advanced, however, by a clever

thief pointing to the beneficent multiplier effect of his efforts to increase the circulation of stolen goods.<sup>5</sup> The two crucial elements in any scheme of insider dealing regulation could be inferred from this analogy: *firstly*, that the structure of the overarching system (whether property rights or the integrity of the market) be protected and, *secondly*, that the things being protected (goods or information) are precisely defined to include items worthy of protection and exclude those that are unworthy.

On the first point, if investors lose sufficient faith in the fairness of the market, this could have serious financial implications. Fewer investors would mean less liquidity and a higher cost of capital. Accordingly, the argument that the belief of investors in the fairness of the market must be secured seems rather convincing.

As regards the second point, defining what information is "inside" and how to sanction its disclosure is more difficult. Most inside information, for instance, falls in the twilight zone and insiders are often simply finding cleverer ways to exploit their knowledge. Well-drawn definitions are indispensable for the prosecution of insider dealing. But even more important are the sanctions provided for by the legislation. "The evidence that Britain's tough criminal prohibitions of insider-trading are less effective than America's approach"<sup>6</sup> seems to suggest that civil sanctions may be more efficient than criminal penalties, at least if criminal prohibitions are not effectively enforced.

The theoretical basis of insider dealing regulation, both on an EU and on an international level has evolved from the strictly corporate-company protection approach embedded in the fiduciary duty theory to the market protection approach and it will most probably evolve towards the direction of regulating privileged information.

The objective of market protection is clearly underlying the EC



Insider Dealing Directive. The latter is a compromise text but has, nevertheless, promoted understanding among Member States that rigorous action should be taken to combat the expansion of insider dealing practices. The EC has taken an undeniably positive step towards harmonising the insider dealing laws in the EU States.

The main deficiency of the EC Directive is that it fails to impose uniform sanctions for the insider dealing offence. As a result its efficiency depends greatly on the severity of sanctions that the Member States have adopted.

The shortcomings of the Insider Dealing Directive are reflected in the way the Directive has been implemented by both the British and the Greek legislators.

As regards the Greek jurisdiction, it should be remembered that the criminal sanctions chosen by the legislator comprise imprisonment and pecuniary penalty. The possible imprisonment sentence (minimum three months - maximum five years) can be considered as sufficient deterrent to potential offenders, whereas the maximum amount of the fine (Drs. 1.000.000.000) has also approached its deterrent objective. The aim of the provision has come even closer to its achievement by linking the measure of the fine to the amount of illegal profit that was made or the loss that was avoided multiplied by five. As far as the prosecution procedures are concerned, since no cases brought to court under Article 30 of Law 1806/1988 or PD 53/92 have been recorded, no overall conclusions can be made. Given that the Greek Stock Exchange has come to flourish fairly recently, the Greek attempt to implement the EC Insider Dealing Directive plays an important role in making all persons involved in stock-market transactions sensitive about an abusive and anti-economical practice which may hamper the operation of a still unsophisticated

market.

Even in the well-organised and developed London Stock Exchange the practice of insider dealing was not illegal until 1980. Until that time "it did not occur to City folk that they were cheating".<sup>7</sup> It was only in 1985 that the Companies Securities (Insider Dealing) Act gave teeth to the law.<sup>8</sup> The Criminal Justice Act 1993 which has just come into force, introduces an innovation by no longer requiring the "insider" to be connected with the company involved. As regards the reactions to this innovation: "The City is squealing, saying the new rules could throttle the legitimate workings of the market. Worse, they could spell the end of the City lunch."<sup>9</sup>

This broader definition of the insider adopted by the Act reflects the international tendency of insider legislation to shift from the company law - fiduciary approach, which perceives as insiders persons with fiduciary duties, to the financial market approach which sets the protection of the integrity of the market as the main priority of the insider dealing legislation. The Act has also done away with the requirement that the inside information be confidential to the company. Consequently, liability can also arise in respect of a broader range of information.

The wide definition of insider dealing has necessitated the adoption of ever more complicated defences that resulted in an increased number of loopholes. In that respect the purpose of the legislation is defied.

The new British Act has mainly failed in altering the sanctions or the enforcement procedures. The criticism of the efficiency of criminal law sanctions and the possibility of affording the victims of the offence civil remedies have been ignored. Closely related to the use of criminal law sanctions are the problems of enforcement that the prosecution mechanism presents. A combination of the complexity of the offence, the inefficiency of the jury system, and the special capabilities of potential



offenders increases the likelihood that the prosecution case come to grief for technical evidential reasons.

Both the Greek and the British Insider Dealing legislation have avoided questioning the validity of the contract of sale of securities where one of the contracting parties commits insider dealing. In other words the transaction tainted by insider dealing is neither *void* nor *voidable*. In both cases the need to protect the certainty of transactions and to avoid upsetting the market has prevailed. The unfair results over the victims that this solution may have could be counterbalanced by affording civil remedies to these individuals. For the Greek jurisdiction this is possible under the general clauses of the Civil Code and in view of the possibility to bring a civil claim to the Criminal Court. If the British legislature adopted substitute civil remedies at a future stage for the aggrieved person to take up, this would greatly supplement the penalties available against wrongdoers and the objective of the legislation could be better served.

According to the results of a survey the new insider dealing regulations of the U.K. which came into force on March 1 1994 have had little impact on the way companies communicate with the City.<sup>10</sup> The sample consisted of the top 350 UK companies and a further 150 smaller companies with replies received from 177.<sup>11</sup> Three quarters of the companies surveyed said they had not changed their attitude to the use of brokers' lunches and only 14 per cent had altered their approach to analysts' briefings. But half said they had changed their opinion on what constituted important information that should be communicated through the Stock Exchange. The new Act apparently created a great deal of confusion among companies given that more than three quarters admitted they were vague or unclear as to the implications for analysts' meetings and only half were confident that they knew the implications for

conducting a take-over. As regards the popularity of the Stock Exchange's suggestion that companies issue quarterly trading statements, only 12 per cent of companies said they would do so with a further 20 per cent considering it.<sup>12</sup> 25 per cent admitted they would consider an announcement if broker's estimates were out of line with current trading.

The results of the above survey should not lead to any premature conclusions on the merits or demerits of the Criminal Justice Act 1993. It is obvious that the Act was received by the City with reluctance, if not unwillingness, to abide by its provisions. The reason may be found in the simple fact that long-established practices of the financial life change very slowly and any innovation is bound to be viewed with suspicion at least at the beginning.

The impact of the recent regulatory reforms and the establishment of the *centralised* FSA remains to be tested.

It has already been suggested that political compromise has limited the effectiveness of the EC achievements. This compromise, perhaps critical to the success of the 1992 programme has necessitated this multiplicity of exceptions and exclusions. The choice of the Community was: "harmony now" at the price of "discord later."<sup>13</sup> The EC has not developed the appropriate institutional mechanism to assure the co-ordination and enforcement of the regulatory system it has created. While regulatory disparities among the Member States still exist, "virtually nothing" has been done to harmonise enforcement. The Directives simply provide for co-operation among the competent authorities. "Investment firms are discovering that the Directives already implemented by EU Member States are enforced competently by some and with "nods and winks" by others."<sup>14</sup> The absence of established disclosure cultures in most European states, coupled with the fear of Regulatory Arbitrage may



aggravate these disparities.

The creation of an international securities commission has been advocated by many commentators. The Paris Bourse put forward a proposal (European List) to members of the Federation of the Stock Exchanges in the EU for a common European listing of the major 250 to 300 European stocks.<sup>15</sup> The proposal is in essence that, while each market would preserve its own procedures and set its own prices for such stocks, the documents and information to be provided by the companies on the List would be standardised and a network would be developed both to inform the national markets of decisions on the stocks and to relay prices. Further, there would be no special procedures to obtain such a Listing and, in principle, no extra fee payable.

The International Stock Exchange in London has put forward its own proposals for an integrated European securities market. The proposals focus on the wholesale, rather than the retail, market, on the theory that the needs of the professional and institutional investor are different from those of the retail investor. The proposal for the European Wholesale Market (EWM) would involve a separate electronic marketplace for shares, based upon the ISE's SEAQ trading system, which would be integrated initially with the wholesale markets in Frankfurt, Paris and Amsterdam. The proposal also requires cross-frontier settlement systems.

EWM membership would be open to any firm with membership on an EU or other eligible stock exchange. Enforcement will be the responsibility of the member's national exchange or other regulatory authority.<sup>16</sup> The above proposals although dictated by the same necessities do not seem compatible.

The problems of enforcement of the Insider Dealing Regulations at a European and an International level are aggravated by the "international"

nature of the offence. The efforts of the EC as represented by the Council of Europe Convention on Insider Trading or the Council of Europe Convention on extradition have not been particularly successful judging by the relatively low take-up that both have had. The problem of extradition of insider dealing offenders which is of the utmost importance for the enforcement of any insider dealing legislation has not been solved so far.

Perhaps the most advanced effort in international co-operation in the area of Insider Dealing Regulation is the EC Directive. It has succeeded in co-ordinating and harmonising the regulatory policy of Member States in the area of insider dealing. It has already been stated that it can provide a model for future co-operative securities regulation efforts in the modern globalised markets.

Regulating insider dealing could be dubbed as "*the art of the possible*". No matter how sophisticated rules will be devised or how many financial and legal experts will be recruited by supervisory authorities no paradise of informational equality can be created. A City professional glued to a computer screen will always get the crucial information before the notorious aunt Agatha in the country.

The modest aim of the present study was to examine briefly the main provisions of the principal measures of community legislation regarding the regulation of insider dealing with a view to protecting investors.

The Community's work on the regulation of dealing in securities has been inspired by two major concerns:

- to ensure the smooth operation of Member States' stock exchanges, and
- to promote a greater interpenetration of national markets in securities.



In order to do so, the Community Institutions took the view that it would be necessary to guarantee a minimum Community level of investor protection, through harmonised disclosure requirements, what the Commission terms "information policy". This policy got off to a rather slow start.

More recently, and particularly since the entry into force of the Single European Act and the sudden progress of Community legislation on the free movement of capital, the Council has made fairly substantial progress in certain areas the sufficiency of which in the long term remains, however, to be seen.

Looking forward, the possibility of common European listings, a shared information distribution system, the electronic linkage of stock exchanges and eventually, a common European securities market, all reflect a trend towards internationalisation of the EU securities markets.<sup>17</sup>

Regulatory harmony could prove fragile. The emergent Single Market for securities and investment services could be better preserved by centralised co-ordination and enforcement which may prove an essential component of the EU's legislative programme.<sup>18</sup> The formation of a European Securities Commission with an aim of promoting regulatory standards within the EU could prove to be the cornerstone of investor protection in the Community.

Those concerned in the accomplishment of a Single Market from the point of view of investor protection should, above all, refrain from any resting on laurels, but continue incessantly their efforts.

## NOTES

- <sup>1</sup> Manning Gilbert Warren III, "Global Harmonization of Securities Laws: The Achievements of the European Communities", *Harvard International Law Review*, vol. 31, number 1, winter 1990, pp. 185-232
- <sup>2</sup> idem
- <sup>3</sup> idem p. 226
- <sup>4</sup> "Ins and Outs: Precise Restrictions on insider-trading can help markets; blunt ones hurt them", *The Economist*, July 16th -22nd 1994, p. 15
- <sup>5</sup> idem
- <sup>6</sup> idem
- <sup>7</sup> David Bowen, "Insider Dealing: a layman's guide", *Independent on Sunday*, 10 July 1994, p. 4
- <sup>8</sup> idem
- <sup>9</sup> idem
- <sup>10</sup> David Wighton, "New dealing regulations have little impact", *Financial Times*, Tuesday August 30, 1994, p. 2
- <sup>11</sup> idem
- <sup>12</sup> idem
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